Ontario. Royal commission on atlantic acceptance

Report

v.3

1969

ONTARIO



# REPORT

of

# THE ROYAL COMMISSION APPOINTED TO INQUIRE INTO THE FAILURE of ATLANTIC ACCEPTANCE CORPORATION LIMITED

THE HON. S. H. S. HUGHES

## VOLUME THREE

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## CORRIGENDA
## in
## VOLUME THREE

**Page iii, last line**
For "223"
read "123"

**Page 1470, line 1**
For "R. A. Daley & Co."
read "R. A. Daly & Co."

**Page 1593, line 23**
For "Limted"
read "Limited"

**Page 1694, line 38**
For "Humphreys"
read "Humphrys"

# Summary of Contents

## VOLUME 1



## VOLUME 2



## VOLUME 3



## VOLUME 4

### TABLES AND APPENDICES

# EDITORIAL NOTE

Throughout the text of the report footnotes are numbered consecutively as they occur within each section under a subheading so that at the commencement of a new subheaded section the numbering reverts to number 1 in each case.

The tables referred to in the text will be found in the volume entitled "Tables and Appendices". Generally speaking the tables and the schedules contained in the text are both in structure and form exactly as entered in evidence, and where errors have been subsequently detected they have been corrected and in some cases amendments have been made for the sake of clarification.

It will be appreciated that the requirement to produce daily copy of the transcripts of evidence has led to some variations from accepted spellings and textual aberrations of other kinds. Wherever possible these have been submitted to the shorthand reporter concerned for reconsideration of his notes and the insertion of errata where necessary in the volumes of evidence. In the few instances where obvious stenographic errors have occurred, and have passed undetected in this process, the necessary changes have been made, although no alteration has been made in the sense of a passage or the language used as transcribed.

# Table of Contents

## VOLUME 3

### Chapter XVI



### Chapter XVII

## Chapter XVIII



## Chapter XIX

## Chapter XX

# CHAPTER XVI

## *The Deeds of Trust*

### Introduction

It is now necessary to return to primary consideration of the affairs of Atlantic Acceptance Corporation, and in this chapter and Chapter XVII, entitled "The Riddle of the Accounts", I propose to examine the method adopted to secure the obligations issued by the company and afford protection to the lenders to it, the nature and value of the security given and the accounting method used to disclose to the holders of Atlantic notes and shares and the public generally the financial position of the company and its compliance with undertakings given to lenders under the provisions of nineteen separate deeds of trust. In the course of this examination, which may well be considered the most significant part of this report in so far as it deals with methods used to conceal the real financial situation of the company, it will be demonstrated that its steady growth and apparent stability was the product of illusion, fraudulently created by its president, C. P. Morgan, with the indispensable assistance of his principal collaborators, W. L. Walton and Harry Wagman whose complicity is beyond question, and of others who lent themselves to his designs for various reasons, some discreditable, but in the main because their habitual watchfulness and sense of propriety had been blunted by their confidence in his ability and good fortune. The sequence of the narrative follows that in which the evidence was offered to the Commission at its public hearings, dictated by the desirability of answering three questions. First, was there default under the provisions of the trust deeds prior to June 14, 1965, assuming that the security given to the noteholders was worth what the company stated it to be? Second, was the value of this security properly reported according to

generally accepted accounting principles? Third, did the company's lending policies and practices conform to the standards generally observed by the sales finance industry in Canada? The first question must be considered in this chapter and the others in the next.

At the risk of repeating some of the observations made in earlier chapters, but in order to make this one in some sense self-contained, further introductory words may usefully be said. At the date of its default Atlantic Acceptance owed to lenders a sum in the order of $133,000,000. Its creditors included financial institutions throughout North America with established reputations for shrewdness and prudence, well deserved and hard-won. They had not loaned such sums without thought for their own protection; they were able to draw upon decades of experience in lending to finance companies to ensure that the borrower conducted its business prudently, kept its lenders informed, and, at least in the case of the holders of senior notes, pledged security of a quality which would virtually exclude the possibility of loss in that category and reduce to a minimum such possibility in any subordinate to it. They retained lawyers of renown to weave a net within which all the assets of the company would be tightly caught as security for the debt, and to provide that the lenders would receive accurate and timely information of any cloud appearing on the borrowers' horizon to permit them promptly to demand repayment while its assets were plentiful and undisturbed by the onset of the storm. The documents prepared to afford such security in the case of Atlantic exceeded 1,500 printed pages, containing provisions for the protection of lenders which had been used for years in respect of loans to finance companies of billions of dollars throughout Canada and the United States. Investment dealers of high repute had acted as agents to arrange such loans with valued clients and they, too, must be taken to have believed, consistent with fairness to the borrower, that nothing was lacking for the protection of the lender which experience and ingenuity might be expected to supply. After Atlantic's default all this labour was found to have been in vain and the great structure of trust deeds, pledged securities, and covenants lay in ashes. The junior subordinated and subordinated noteholders, notwithstanding that they ranked in right of payment ahead of the shareholders' equity alleged to exceed $15,000,000, lost all their investment of $21,000,000 and even those who were both senior and secured sustained a further loss of at least a like amount. Disaster had struck without warning and the elaborate provisions for monthly, quarterly, and yearly reports of the financial condition of the borrower, with all the certificates required and furnished, were seen to be useless—an early warning system which failed to warn. Apart from the important matter of priority among lenders—and even this is being called into question before the courts—it would be difficult to prove that the

existence of the trust deeds and all the related documents affected the issue in the slightest degree, advanced in the least the date of collapse or reduced the loss by one dollar. Having regard to the immense sums loaned daily in our economy on terms substantially the same as those employed in respect of Atlantic, the study of how such loss could occur in these circumstances without warning may not be the least important nor the least useful part of this report.

The history and development of the bond mortgage as a means of providing security for money lent to limited liability companies is a proper study of itself upon which it is not intended to embark. Governments and municipal corporations are not now expected to do more than promise to repay with interest the loans that they contract, although as late as the eighteenth century valuable monopolies and concessions were granted to lenders as a pledge of repayment. Individuals and companies have generally been in different case, and the practice of consolidating the security given to a number of different lenders by mortgaging a company's property in favour of a trustee, who covenants with it to act on their behalf, was first resorted to in England in the early part of the last century, and in connection with the issue of what is known as "debenture stock". The instrument conveying to a trustee legal title to the property and assets of the borrower, defeasible upon performance of its covenants and exercisable upon the breach of any of them, is known as a deed of trust or trust deed, or in American parlance, which appears now to find favour with government draftsmen in Ontario, as a trust indenture. The issue of debenture stock secured by a trust deed was not, however, much resorted to in England until the last decade of the nineteenth century; thereafter it became a favourite method of providing security for lenders to companies in Britain and its dominions and the United States. In the latter and in Canada the word "bond" is habitually used to describe the same type of obligation which in the United Kingdom and other countries of British origin is termed "debenture stock" and the bonds of commercial corporations have almost invariably been secured by a bond mortgage in this country up until the present day. In Chapter I the fashion, some twenty years old, among finance companies in the United States of referring to such obligations as "notes", and its inevitable adoption in Canada, has already been noticed, and at a later stage of this chapter it will be necessary to discuss the significant change in the manner of securing finance company obligations caused by the impact in the United States of the Trust Indenture Act of 1939.

The trust deeds of Atlantic Acceptance were given in every case to the Montreal Trust Company as trustee to secure senior, subordinated and junior subordinated notes. They were closely considered by Mr. Shepherd, as counsel for the Commission, and he instructed Mr. A.

Ross James, C.A., of Touche, Ross, Bailey & Smart to examine the accounting records and internal working papers of Atlantic Acceptance and its subsidiary companies and report upon all aspects of Atlantic's compliance with the covenants into which it entered with the trustee for the various classes of noteholders. Mr. James' evidence[1] was given to the Commission on October 26 and 27, 1966, accompanied by a number of documents and explanatory schedules,[2] and constitutes a dialogue between lawyer and accountant which, in spite of the infinite complexity of the subject matter and the fact that it occupies 300 pages of transcript, is a lucid and exhaustive analysis and should be read in its entirety by both expert and student. On this evidence this chapter chiefly depends, as well as upon a commentary prepared by Mr. Shepherd to assist me in writing it, and upon which I have heavily relied. An effort has been made to avoid encumbering it with more than is necessary of the bewildering detail of the evidence itself. But before proceeding to deal in detail with those provisions of the trust deeds which were vital to the security of the lenders, and essential to the borrower to comply, or appear to comply with, a brief resumé must be given of the principles applicable to borrowing by finance companies in general, and the way in which Atlantic's borrowing fitted into the common scheme of things, with particular emphasis upon the period prior to February 1, 1961 which was the date of the first trust deed securing an issue of senior notes.

### Principles of Secured Lending to Finance Companies

As do all finance companies, Atlantic depended for its profit on lending money at a rate of interest higher than it paid to borrow the money, with that difference being enough to meet its operating costs and leave a surplus. Of course it was not enough to lend the money at high interest; Atlantic had also to collect that money back again when the loans fell due. Atlantic's inventory was money and it could and did obtain some money by selling shares, but certainly no finance company could prosper if it relied only on the comparatively small sums to be raised by selling these. Indeed, a finance company which could not or did not borrow money would be so limited in the scope of its operations that its shares could hardly be sold at all, and it would soon cease to do business. The principal purpose of raising money by selling shares is to facilitate borrowing by providing money which ranks after borrowed money in priority of claim against the assets of the company, thereby affording a greater measure of security to the lender.

Finance companies, then, as a group are among the largest borrowers of capital in our economy. Mr. Abell's report, reproduced in

[1]Evidence Volumes 75-6.
[2]Exhibits 3434-70.

Chapter XIX, shows that in 1964 the aggregate of finance company borrowing in this country was in excess of $1,160,000,000. Only a small percentage of this money was borrowed from chartered banks; in the later years of Atlantic's history less than 10% of its debt was owed to banks. The chartered banks were then limited by law to an interest rate of 6% per annum on money loaned by them and it is understandable that they should prefer to place that money with clients and customers whose business was not, as was that of finance companies, conducted in competition with them.

Finance companies of reasonable size and maturity borrow in the main from large institutions, such as insurers who have surplus funds to invest both for long and short terms, and from the public which lends in smaller amounts and is usually content to accept a higher risk for a higher return. They follow the practice of executing an agreement with a trustee, the trust deed, providing that all those who lend money to the company by purchasing promissory notes of the class designated in that agreement are entitled to the same security and enjoy the same priority in the event of default by the company, irrespective of when a note is purchased by the lender or for what term, amount, or rate of interest. Notes secured by the trust deed are then sold for long-term repayment usually within periods of over three years, for medium terms of over one and under three years, or for short terms of less than 365 days; the interest rates vary with the term of the note sold and correspond with the price money commands on the market on the day on which any given note is sold; but one noteholder has the same priority and security as any other whose debt is secured by that particular trust deed.

A review of the borrowing of other large finance companies during the period of Atlantic's existence discloses a common pattern. Debt was created in layers, each designed to meet the desires of different kinds of lenders, with the interest rate varying in indirect ratio to the order of priority in which the lenders could look to the assets of the company if it became necessary to enforce the charge upon its assets which provided security for their loan. Differences in priority were achieved by executing different deeds of trust and designating the notes respectively secured thereby as "senior" or "subordinated" and the like, to indicate the differences in priority which the deeds of trust set out in detail. Some companies had as many as four layers of debt; Atlantic at the time of its default had three. Below the debt in priority are usually to be found preference shares and Atlantic had three classes of these. Last of all was the common stock.

First in order of priority is always the senior debt, issued for various terms ranging from demand to twenty years which is entitled to be paid first if the borrower defaults, and is further secured by a first

charge upon specific receivables in an amount in excess of the amount of senior debt; in the case of Atlantic, receivables aggregating 115% of the amount of senior debt were required always to be pledged with the trustee for the security of senior notes. This debt was incurred between February 1961 and June 1965, the interest rate varied from 5% to 6½%, and banks and other large institutions were the principal purchasers. Treating United States and Canadian dollars as equivalent, a total of about $50,000,000 was outstanding at the date of default on long or medium term; the remaining senior notes were short-term in the sum of about $59,000,000, including accrued interest and the S.F.C.I. note which was the occasion of default, but excluding premiums payable on redemption.

Next is the subordinated debt which has no assets specifically pledged for its security; its holders are unsecured creditors but are entitled to look for its repayment to all the assets of the company which are left after the senior debt is paid. In the case of Atlantic the interest rate on this type of debt varied from 6% to 6¾% but the loan made by the United States Steel and Carnegie Pension Fund in 1959, of which more will be said, and which ultimately fell into the category of subordinated debt and was the first of that class, was also accompanied by share warrants. At the date of default $16,798,820 of subordinated debt was outstanding, and the trustee's list of noteholders at Appendix E sets out the names of the lenders. Atlantic sold its last subordinated notes in May 1965. The $4,500,000 in principal amount sold to the Canadian public at large in comparatively small amounts was secured by a trust deed dated June 1, 1963 and the balance was held by institutional lenders in the United States.

Below the senior debt and the subordinated debt is usually to be found a third layer, entitled junior subordinated debt, which can look for payment only after the other two classes of debt have been wholly paid. Atlantic first sold such notes in July 1964, and their terms varied from eighteen months to four and one-half years and the interest rate varied from 6% to 6¾%, rates which, in the halcyon days of 1964, were thought to be substantial. A total of $4,050,000 of these was outstanding at the time of default, having been purchased by institutions which acquired them as part of a "package" of senior notes and junior subordinated notes, and by the ever faithful British Mortgage & Trust Company which purchased, on April 23, 1965, $1,000,000 of this debt payable in 364 days.

Ranking after all the debt of a finance company there may be preference shares and Atlantic's three classes were designated first, second, and third, indicating the order in which the respective shareholders could look to assets to recover the par value of their stock after all debt was fully paid. At the date of default first preference shares of

Atlantic with a par value of $290,300 were outstanding, were entitled to a cumulative dividend of 5½% and were convertible into common shares on a basis of share for share. These had been issued in the early years of the company's existence, commencing in 1953, to a few members of the public. The Series "A" second preference shares, to the number of 190,000, were outstanding with a par value of $24, issued for $4,560,000. The cumulative dividend was 6% and the shares were convertible into common shares at a price of $20.81 each, or 1.153 common for each such preference share. As will be seen, 125,000 of these shares had been sold at par to institutions—or so it was alleged by the company—in 1962 and the balance sold to the public in May 1963 at $25 per share. The 10,000 Series "B" preference shares had preferences identical to those attached to Series "A" and were all bought by Connecticut General Life Insurance Company in 1962. Sixty thousand third preference shares had been issued to the United States Steel and Carnegie Pension Fund in connection with its 1959 subordinated loan when that loan was made, and thereafter to satisfy anti-dilution provisions affecting these shares in later years when the company increased its issued common stock. The par value outstanding at default was $128,000 and the shares participated in dividends equally with common stock and were convertible; 50,000 of them had been converted into common stock. In the aggregate the company raised $5,218,300 by selling preference shares of all classes.

Last in point of priority is, of course, the common stock of a finance company and during its existence Atlantic issued 699,718 common shares for an aggregate of $9,236,787, or an average price of $13.20 per share.

By the date of default Atlantic owed to lenders and had obtained from shareholders, in Canadian dollars, the following sums, including accrued interest but not premiums payable on redemption of notes, provision for which was no longer necessary by reason of the default:

| *Type of Security* | *Amount* | *% of Whole* |
|---|---|---|
| Senior Notes | $109,694,406 | 75.8 |
| Subordinated Notes | 16,397,550 | 11.3 |
| Junior Subordinated Notes | 4,351,679 | 3.0 |
| First Preference Shares | 290,300 | .2 |
| Second Preference Shares "A" and "B" | 4,800,000 | 3.3 |
| Third Preference Shares | 128,000 | .1 |
| Common Stock | 9,236,787 | 6.3 |
| | $144,898,722 | 100.0% |

In addition the last annual report before default, that for the year ended December 31, 1964,[1] showed retained earnings of $1,451,076. Had

[1]Exhibit 45.

the noteholders examined their security immediately before default and relied upon the accuracy of the company's records, no concern would have been felt. The senior noteholders would have seen that, quite apart from their specific security of pledged receivables, their priority meant that any loss by the company must exceed $35,000,000 before they could be affected. A loss of such magnitude could scarcely have been conceived of in the light of Atlantic's audited financial statement. The subordinated noteholders would have seen some $20,000,000 exposed to loss before any part of their debt was imperilled. The junior subordinated noteholders could have discerned $15,000,000 ranking behind them to provide a cushion against loss, a sum large enough at least to warrant the belief that there would be ample warning of difficulty before the company faced a loss large enough to affect them.

This description of Atlantic's position with respect to borrowed and invested money will illustrate the importance which any prospective lender to a finance company must attach to the money available to the debtor company as a result of borrowing which ranks, in priority of claims against its assets, behind the money sought from him. Provided loans were made on rational terms, the more money the company owed on subordinated debt the safer was the senior debt. It was of no consequence to a senior noteholder whether the money junior to him was represented by subordinated debt or by equity; it was money and it was junior, and these were the qualities which mattered. In the event of insolvency the company's creditors would attack. Before they could intrude upon the position held by senior noteholders, the assault must be of a scale which first wiped out the common shareholders who held, as it were, the forward defended localities. Then the lines occupied in succession by the third, second and first preference shareholders must be taken, the junior subordinated noteholders must next be entirely eliminated, and finally the subordinated noteholders must be despatched to a man before the position of the senior noteholders could be reached at all. Even in that event, this was fortified by a specific charge upon pledged receivables which were beyond the reach of any other creditor. To continue the metaphor, the more troops in the form of money to be found in these forward lines the safer the senior debt must be, and the same consideration applies to the subordinated debt. The junior subordinated noteholders directed their attention to ensuring that there was enough equity money exposed to creditors to protect their own position.

During decades of experience in lending to finance companies, large institutions had evolved principles governing the ratio which money loaned on a junior security should bear to money loaned on a senior security, if the latter were to have the greatest protection it was reasonable to exact while leaving the debtor company with reasonable access to borrowed money. A review of other finance company borrowing during

the first half of this decade shows that senior debt usually was protected by a covenant that the company would not create such debt in excess of a ratio ranging between 200% and 400% of the total of debt junior to it, plus the consolidated net worth of the company. Consolidated net worth is always defined in a trust deed but, broadly speaking, it is equivalent to shareholders' equity, less intangible assets such as deferred branch development costs. As we shall see, this limitation in the case of Atlantic was 350%, a comparatively generous treatment of the debtor company. Subordinated debt was usually protected by a covenant that the company would not create this class of debt in excess of 125% of consolidated net worth. Atlantic enjoyed a more favourable ratio as a borrower; it was allowed to create subordinated debt up to 150% of consolidated net worth. Junior subordinated debt usually could not be created in a ratio greater than 100% of the consolidated net worth and this was the ratio in the case of Atlantic.

It will be seen, therefore, and it has been observed before, that finance companies must borrow money if they are to do business. They borrow by creating different classes of debt, whereby any lender in one class has the same priority in the event of default as every other lender in the same class. The lenders do not allow the company to borrow what it pleases from anyone who will lend; they require it to have a certain minimum of money junior in right of priority of claim upon its assets before it can create debt of any given class. Senior debt is by far the safest and, therefore, the cheapest and easiest money to borrow. Before any institution will lend cheaply and easily it requires for its safety shareholders' equity and debt junior to it, in sums ranging from one-third to one-fifth of the senior debt, to provide a cushion on which loss will fall first in the event of insolvency. Subordinated classes of debt have like requirements of certain minimums of money junior to them. In Canada senior noteholders also require the pledge of specific receivables, in an aggregate amount exceeding the total senior debt from time to time outstanding by a certain specified percentage to provide a margin for safety. It would be idle to specify all these ratios unless the company were also required to give frequent reports to its lenders disclosing whether it was keeping within their limitations or not, and the deeds of trust always require such reports designed to disclose that information. Many other covenants are commonly exacted in a trust deed, and were exacted in the case of Atlantic, to require prudence in respect of its own lending and the avoidance of undue concentration of loans, whereby the debtor company could sustain heavy loss from the failure of one of its customers. The more important of these covenants by Atlantic will be examined hereafter.

What has gone before is a description of how all large and mature finance companies raise the money they require to do business. Until

about 1960, however, Atlantic was neither large nor mature by any standard, and could not have borrowed by selling its notes under the security of a trust deed of general application because it did not possess significant sums ranking in priority behind senior debt. In its early years, even with the assistance of a very liberal view as to what constituted adequate provision for losses, the company was not sufficiently profitable to permit the hope that the foundation for large-scale borrowing could, during the remainder of this century, be constructed out of retained earnings. Large sales of stock and the discovery of lenders willing to advance money for a long term of years, permitting their loans to be subordinated to loans made thereafter by others, were required before the company could hope to gain access to the money market and the large lenders who demanded the security of senior notes ranking ahead of millions in junior money.

### Atlantic Borrowing Before the First Trust Deed

Chapter II of this report has told the story of the borrowing and sales of equity of Atlantic Acceptance in those difficult years. By June 30, 1955 the company had sold its stock to the public to the value of $330,000. In that year Lambert & Co. loaned $300,000, a debt subordinated to that of the banks and other future lenders but being represented by convertible debentures conferring a right to acquire shares. As a result, in the following year the company was able to double its bank borrowing from $340,000 on June 30, 1955 to $675,000 one year later. By the end of 1957 it was able to borrow $845,570 on short term from lenders other than banks, giving to each of them specific security, ranging as high as 150% of the loan, in the form of assigned accounts receivable, and the bank increased its loan to $1,415,421. Now it became possible to interest investors in purchasing shares and in 1958, 114,953 common shares were sold to the public for $574,765, for a total invested capital of $914,265 to which should be added retained earnings of $78,027. Keeping in mind the ratios already described, which lenders customarily demanded respecting different classes of debt, the position of Atlantic at the end of 1958 was approximately this:

| | | |
|---|---|---|
| Consolidated net worth (adjusted) | | $900,000 |
| Subordinated debt (Lambert & Co.) | | 300,000 |
| Senior Secured Debt—Banks | $1,258,000 | |
| —Others | 470,000 | |
| Total Senior Debt | $1,728,000 | 1,728,000 |
| Ratio of Senior Debt to Consolidated Net Worth plus Subordinated Debt | 144% | |
| Ratio of Subordinated Debt to Consolidated Net Worth | 33% | |

Brick by brick the foundation was being built. There was now room for more subordinated debt within the ratio usually required, and if that ratio were to be as high as 150% of consolidated net worth, then a loan of about $1,000,000, to rank equally with the Lambert loan, appeared feasible. There was already room for more secured debt and a further subordinated loan would permit such debt to be substantially increased.

In 1959 the loan of $2,500,000 in U.S. funds was made by the United States Steel and Carnegie Pension Fund, evidenced by 6½% subordinated notes due in 1979. The Pension Fund also purchased 10,000 convertible preference shares, which became third preference shares, at $10 each, and Consolidated Toronto Development Corporation, to which its grandparent Lambert & Co. had transferred it, converted its subordinated debt to common shares, thus further broadening the "borrowing base". The Pension Fund received share purchase warrants entitling it to buy 50,000 convertible preference shares at $10 per share and also a premium of $144,500 in U.S. funds on the issuing of the notes. After deducting the premium the true rate of interest is seen to be 6⅞%. A further investment in subordinated debt not caught by any of the trust deeds securing that category, being prior in time to the first indenture for subordinated notes, was made on September 27, 1961 in the amount of $3,700,000 in U.S. funds and $25,000 in Canadian funds for twenty years.[1] The purchasers, of which the Ford Foundation was by far the most substantial, lending $3,500,000 in U.S. funds, received a bonus of 26,609 common shares and 53,215 warrants to buy common stock at $25 in Canadian funds on or before June 1, 1968. The acquisition of another lender of such unassailable prestige had consequences far transcending any additional broadening of the borrowing base and encouraged many others, besides Wilfrid Gregory, to regard the list of lenders to Atlantic as "a blue book of finance".

As Mr. Abell states in his report,[2] the Pension Fund had followed the practice for some time of making investments in unsecured debt, but with a bonus of warrrants to buy common shares, or shares convertible into common at its option, and this policy had proved highly successful. Many young firms in Canada have benefited from it and justified the confidence placed in them by what was then an imaginative and resourceful employment of capital. Mr. Abell was told by many investors that they were not influenced in their decision to buy Atlantic notes by the fact that many others who were highly regarded had already bought them and, indeed, several claimed not even to know that other lenders were of high quality. Perhaps this is true of very late investors, but at the time of the Pension Fund investment, and the later Ford Foundation investment, the fiscal agents selling the notes of Atlantic were

[1]Exhibit 3438.
[2]Chapter XIX.

not Kuhn, Loeb & Co. but Annett & Co. and Lambert & Co. It is difficult to believe that a potential investor approached by either of them had withheld from him the information that, in becoming an Atlantic lender, he would join distinguished company, and that any such investor was not impressed to see money from such sources subordinated to the loan he was being asked to make.

The beneficial effect of the Pension Fund loan was felt almost at once. At the end of the month in 1959 in which it was made Atlantic owed to secured lenders, other than banks, $5,546,607. One year later, by December 21, 1960, this debt had more than doubled and had risen to $11,438,429. These loans were described in the financial statement of Atlantic on December 31, 1960[3] as being "secured", although there is no note to state what the nature of the security was, and no information whatever in the working papers of the company's auditors, Wright, Erickson, Lee & Co. of Hamilton, for that audit respecting the nature, amount, or even existence of security. Its nature, if it existed, should have been disclosed in a note to the financial statement and an explanation should certainly appear in the working papers of the auditor. The question of what secured over $11,000,000 of debt for a company the size of Atlantic Acceptance in 1960 was not a question on which one reading the financial statements should have been required to speculate. The interest rates paid on these loans vary from 3½% to 5% for loans made for similar periods and advanced on substantially the same date. This would suggest that some of them may have been secured by pledged receivables and some may not have been specifically secured. In any event, investors were much readier to lend secured short-term money to Atlantic after the subordinated Pension Fund loan and the company looked out on bright vistas.

Other lenders followed the trail blazed by the Pension Fund and loaned large sums on subordinated notes for long terms, with a bonus of warrants to buy common shares. On December 1, 1960 the Trustees of Princeton University loaned $500,000 on such terms, and the J. Walter Thompson Trust loaned $200,000 together with small lenders.[4] The Pension Fund loan was generous in amount for subordinated debt of a finance company of the size and youth of Atlantic Acceptance. The lenders were no doubt content to accept the higher risk because of the option to buy common shares. Had the Pension Fund exercised its options near the top of the market they would have made a net profit on the warrants in the range of $1,000,000.

These lenders of subordinated money presumed, of course, that they were lending to honest men. If those with money to lend to borrowers apparently respectable were not prepared initially to assume that

[3]Exhibit 41.
[4]Exhibit 3436.

reasonable standards of commercial probity would be maintained by their debtors, business could not be carried on. The managers of the Pension Fund knew Alan T. Christie whose employment with the Bank of New York had brought him into contact with men highly placed in the financial world. They had no reason to doubt his probity or competence and had every reason to place confidence in both. They knew of Great Northern Capital Company—later, in 1962, the Pension Fund acquired an indirect interest in that company by investing in Lambert International Corporation—and knew that, through its subsidiary Consolidated Toronto Development, it was the principal shareholder of Atlantic. No doubt they assumed that the board of directors of Atlantic included men, effectively appointed by the Lambert interests, who would ensure that the safeguards against fraud, theft, and even simple incompetence in lending, usually established in any such company, were so established and maintained in Atlantic. They did not need specifically to ask whether that company was operated on the principle that one man alone was empowered to lend any amount to any borrower without even the knowledge, let alone the consent of any one else in it, or that the same man single-handed operated a subsidiary, Commodore Sales Acceptance, with the directors of Atlantic unable to make even an informed guess as to what he was doing. In short, the early lenders of subordinated money must be taken to have assumed that the audited financial statements were correct, that the directors were reasonably active and adequately informed, and that the management employed by those directors was honest. They were wrong on every count.

By December 31, 1960, as appears by its comparative condensed financial statements,[5] Atlantic Acceptance possessed an aggregate of approximately $5,500,000 represented by subordinated debt and consolidated net worth. If senior secured noteholders were to require a limitation on the senior debt which could be created of 350% of debt and equity ranking behind them, as they did, then Atlantic Acceptance would be able to create over $19,000,000 in senior debt if it could attract lenders in such amounts. The company then owed just over $11,000,000 in secured debt, so it can be seen that there was room for more borrowing. For reasons given below the proper course for the company to follow, had its financial affairs been in order, was to enter into a deed of trust and pledge the security of receivables with the trustee for the benefit of senior noteholders.

Up to this time Atlantic had borrowed, for what it then called "short-term", upon secured notes, by entering into a separate contract with each lender and pledging securities with a trustee for that lender. The ratio of security to the loan was different in each case; the trustee was often different; different lawyers acted for the various lenders, all

[5]Table 1.

at the expense of the borrower; the contracts relating to the loan were all different and each needed to be examined by every new lender to ensure that they did not adversely affect him. The process was expensive and time-consuming. Although the company then called these loans "short-term" nearly all were for the term of one year or more. It was impossible for it to borrow from those who wished, for example, to lend for seven days and to put the money out at interest on the very day they first decided to lend it, because the documents and searches required to protect the lender would require many days or even weeks to complete. Mr. Abell has described the rise of the money market in Canada of which "commercial paper", or loans for less than six months, was the mainstay. There were now many millions of dollars which could be borrowed for very short terms, as little as one day, and it was available in such quantity that a borrower could reasonably expect always to have the use of large sums, although the identity of the lenders might change from day to day. It could not seek to borrow this money unless it had created an instrument, a deed of trust, in which was set out once for all, all the terms of the loan relating to security, priority, and limitation on what it might do while indebted. A lender could read such a document once, thereafter purchase simple promissory notes issued pursuant to its terms and would know that these would be constant from one day to the next, its security always present and that it ranked equally with every other purchaser of notes under that instrument, no matter when they had been bought. In these circumstances loans could be arranged over the telephone and the complete documentation, which consisted solely of filling in blanks on a printed form of promissory note, could be completed and delivered against payment in a matter of minutes. The trust deed had advantages in relation to long-term and medium-term lending as well, but lenders on those terms always required a supplementary trust deed relating specifically to their loans and there was time to prepare it. The trust deed, therefore, was convenient for the longer-term loan, but it was essential for the sale of commercial paper and it was there that much money was to be found. Atlantic Acceptance, on February 1, 1961, executed its first trust deed securing senior notes in favour of the Montreal Trust Company as trustee for their holders.

### Outline of the Atlantic Trust Deeds

A list of the trust deeds made in favour of the Montreal Trust Company, from the first one dated February 1, 1961 with the eleven supplements to it, to secure senior notes, and those securing subordinated and junior subordinated notes with their dates of execution, exhibit numbers in the Commission's evidence, series numbers of the long-term

notes issued thereunder and the face amounts of the loans which they secured, was compiled by Mr. James and is reproduced below:[1]

SCHEDULE SUMMARIZING LONG-TERM NOTES
ISSUED UNDER TRUST INDENTURES

| | | Dated | Exhibit | Series | Issue date | $ |
|---|---|---|---|---|---|---|
| SENIOR | | | | | | |
| | Original | Feb. 1/61 | 48 | A, B | Feb. 8/61 | 4,000,000 U.S.<br>1,000,000 Cdn. |
| 1st | Supplemental | Sept. 15/61 | 49 | C, D, E, F, G | Sept. 29/61 | 2,000,000 Cdn. |
| 2nd | Supplemental | Apr. 18/62 | 50 | H | June 1/62 | 700,000 Cdn. |
| 3rd | Supplemental | May 15/62 | 51 | I | June 1/62 | 1,250,000 Cdn. |
| 4th | Supplemental | June 8/62 | 52 | J | June 15/62 | 2,250,000 U.S. |
| 5th | Supplemental | June 22/62 | 53 | K | June 29/62 | 1,500,000 U.S. |
| 6th | Supplemental | Sept. 24/62 | 54 | L, M | Oct. 1/62 | 5,000,000 U.S. |
| 7th | Supplemental | Jan. 15/63 | 55 | N | Feb. 1/63 | 7,500,000 U.S. |
| 8th | Supplemental | July 15/64 | 56 | O | July 15/64 | 1,500,000 Cdn. |
| 9th | Supplemental | Aug. 20/64 | 57 | P | Sept. 1/64 | 1,500,000 U.S. |
| 10th | Supplemental | Sept. 15/64 | 58 | Q | Sept. 25/64 | 8,500,000 U.S. |
| 11th | Supplemental | Feb. 1/65 | 59 | R | Feb. 26/65 | 5,460,000 U.S. |
| 12th | Combination of all above) | Mar. 15/65 | 47 | — | — | — |
| | Composite | — | 3434 | — | — | — |
| SUBORDINATED | | | | | | |
| | Original | June 1/63 | 780 | 1 | June 1/63 | 4,500,000 Cdn. |
| 2nd | Supplemental | | | 2/3 | | Nil issued |
| 3rd | Supplemental | Feb. 1/65 | 3313 | 4 | Feb. 26/65 | 2,340,000 U.S. |
| 4th | Supplemental | May 15/65 | 3314 | 5 | May 15/65 | 2,000,000 U.S. |
| JUNIOR SUBORDINATED | | | | | | |
| | Original | July 15/64 | 3310 | 1 | July 17/64 | 2,000,000 U.S. |
| 1st | Supplemental | Aug. 15/64 | 3311 | 2 | Sept. 1/64 | 500,000 U.S. |
| 2nd | Supplemental | Sept. 28/64 | 3312 | 3/4 | Sept. 30/64 | 550,000 Cdn. |

Some observations about the list are necessary. In the first place, only the long-term issues, extending for periods from over three and up to twenty years, are recorded in the right-hand column, the more than $50,000,000 of short-term notes being issued under the provisions of the original indenture dated February 1, 1961. In the second place, the twelfth item under the heading "Senior" was a combination of all its predecessors and was prepared by the company's solicitors, Messrs. Osler, Hoskin & Harcourt of Toronto, to facilitate and reduce the cost of registration in the different jurisdictions in which this was required. In the third place, the document described as "Composite" was prepared by the company itself for the sake of convenience, to incorporate the provisions of the original trust deed and of all the first ten supplements to it, and is the document annexed to this report as Appendix K.[2] Although this composite indenture does not comprehend any of the minor differences appearing in the eleventh supplemental trust deed dated February 1, 1965, it was used by Mr. James for reference and analysis in the evidence which he gave, because of the convenience of its arrangement and of the fact that it was not varied in any material

[1]Exhibit 3437.
[2]Exhibit 3434.

particular by the eleventh indenture. Where references are made in this chapter to specific clauses by number they reflect the numbering which prevails in the composite indenture, in turn derived from the original of February 1961. According to the information given to the Commission, the original trust deed securing senior notes was prepared by the well-known New York firm of Sullivan & Cromwell and the supplemental instruments either drawn by them or adapted from the original by other hands. The same may be said of the trust deeds securing subordinated and junior subordinated notes and, although the names of the drafting attorneys do not appear on any of these documents, their American origin and their special adaptation to the requirements of lenders investing in finance company notes is obvious from the language used. Such expressions as "stockholders", as a synonym for "shareholders", and "provision for credit losses" for "allowance for bad debts" may be noted in passing.

In Chapter X, dealing with the transactions of Atlantic Acceptance and the Hugo Oppenheim Bank in Berlin, some general observations on the mechanics of the deeds of trust have already been made under the heading: "Effect of the Sale of Shares on Atlantic's Capacity to Borrow."[3] The senior notes, no matter what the length of their term, could not be outstanding at any time in an aggregate amount greater than 350% of the sum of the company's consolidated net worth and any subordinated debt incurred by it. "Consolidated net worth" was specially defined in the trust deeds and it is important to note in what particular that definition differed from what is usually accepted in accounting parlance. In the Canadian Institute of Chartered Accountants' very useful "Terminology for Accountants", published in 1962, net worth is defined as "the book value of the owners' equity in a business" and, by reference to the definition of "Capital", as "represented by the excess of the total assets over the total liabilities to outside interests". The definition of "Consolidated Net Worth" contained in the original trust deed securing senior notes of February 1, 1961 is as follows:

> "1.01 . . 'Consolidated Net Worth' means the excess of the assets of the Company and its Subsidiaries (other than write-ups subsequent to September 30, 1959 of assets above cost, debt discount and expense and intangible assets such as good will, excess of cost of investment in Subsidiaries over book value of the assets thereof, and trade-marks), over all (i) indebtedness and other liabilities of the Company and its Subsidiaries, (ii) reserves, other than reserves which are deducted from assets or which, in effect, are appropriations of earned surplus, and (iii) appropriate provisions for the minority interests, if any, of other persons holding stock in any Subsidiary, all as set forth on a consolidated balance sheet of the Company and its Subsidiaries prepared in accordance with generally accepted accounting principles."

[3] pp. 688-90.

For the purpose of calculating the permitted limitation of the amount of senior debt outstanding an additional restriction was imposed under section 6.12(2), in that the company was required to deduct from consolidated net worth, as defined, "the book value of the fixed assets of the Company and its Subsidiaries". The senior notes were secured by a fixed and specific first charge on "Finance Receivables", assigned to and pledged with the trustee as mortgagee, and a first floating charge on all the assets of the company. The company obligated itself in this respect to pledge at least 115% of the amount owing on senior notes at any time, and to place them physically in the possession of a depositary appointed by the trustee which, in the event, was the Toronto-Dominion Bank. "Finance Receivables" were defined as "receivables arising from the Finance Business, excluding that portion of the same taken in payment of delinquent interest, but also excluding any such bills, notes and other negotiable instruments representing indebtedness of any Subsidiary to the Company or to another Subsidiary". There were also provisions requiring that the pledged receivables be not in default and limitations on the size of any one of them, to the end that the security of the noteholders would not be imperilled by a concentration of loans among a few borrowers whereby it might be drastically reduced by the bankruptcy of one of Atlantic's customers. These provisions must be considered in some detail below.

It can safely be said that, in general, the supplemental indentures added nothing to the security provided by the original of February 1, 1961, under which short, medium and long-term notes could be issued up to the permitted limit and at different rates of interest, but it was customary for purchasers of a new series to be tendered a separate document in which their rights and the obligation of the borrower was set out. The fourth supplemental indenture, entered into on June 8, 1962 for the benefit of purchasers of Series "J" long-term notes, was, however, of a different order. The purchasers of this series, with a face value of $2,250,000 in U.S. funds, were the Lincoln National Life Insurance Company and the Guardian Life Insurance Company of America, and the additional covenants which the latter required from the company, as set out in that instrument, are identified in the composite deed to be found at Appendix K. Whereas the original trust deed securing senior notes allowed the company thirty days after notice in which to cure a breach of the covenant to limit outstanding senior debt to the 350% ratio before it would be declared due and payable, the fourth supplemental indenture provided that a breach of this covenant, among others, constituted immediate default at the option of the trustee, unless it arose from a shortage in consolidated net worth, in which event the company was allowed ten days to cure it. Moreover it was provided in the supplemental deed that the company would at all times have outstanding at least $1,250,000 in either U.S. or Canadian funds repre-

sented by borrowings from banks in good standing under the banking laws of the jurisdiction in which they were located, and that its consolidated net worth would at all times be not less than $2,500,000. Other restrictions imposed in this instrument with respect to senior notes, which were incorporated in the trust deeds securing subordinated and junior subordinated notes thereafter, will be referred to again as they become relevant; they included an attempt to limit the amount of pledged receivables derived from separate categories of the finance business, such as loans for the purchase of automobiles, house trailers and domestic appliances, and to finance construction, inventories and the factoring of trade receivables.

All notes issued under the original deed of trust securing senior notes and the deeds supplemental thereto were declared to have equal rank, and none could be sold if the issuing company were in default under any covenant into which it had entered with the trustee. Under the original deed Atlantic Acceptance created Series "A" long-term senior notes in the amount of $4,000,000 U.S. funds and Series "B" in that of $1,000,000 in Canadian funds, and the sale of "commercial paper" began forthwith in February 1961. Commercial paper consists of short-term promissory notes usually payable between thirty days and six months after the date of issue and occasionally payable on demand. Its purchase by companies and institutions from time to time with large amounts of unused cash at their disposal is a characteristic feature of the money market. By the end of 1961 Atlantic had issued approximately $21,000,000 worth of senior notes of which only $4,000,000 in U.S. funds and $3,000,000 in Canadian funds were long-term. Of this senior debt some $10,300,000 was represented by short-term notes and there was, in addition, subordinated debt of $7,000,000, unsecured by any deed of trust. Thus the problem of liquidity materialized early in the history of the company's operations in the money market. In the United States it is not uncommon for lenders to finance companies of long-term money to require that short-term debt be not created in excess of a borrower's cash and unused lines of bank credit, a wise provision to which Atlantic and most Canadian finance companies were never subject and which, if applied to Atlantic borrowing as early as 1961, would have entirely inhibited the "crescendo" nature of its apparent growth, since its bank lines amounted to no more than $3,700,000 and were never unused.[4] The dangers inherent in this spate of short-term borrowing, which by the date of Atlantic's default had become an outstanding liability of $59,000,000, were underlined by the provision of the deeds of trust securing subordinated and junior subordinated notes.

Before June of 1963 subordinated notes, as has been seen, were not subject to the terms of a trust deed, each lender being party to a separate

[4]Exhibit 594.

contract with the company, except that, by the provisions of the sixth supplemental indenture of September 1962, subordinated debt was not to exceed 250% of consolidated net worth. On June 1, 1963 the first trust deed securing subordinated notes was executed by Atlantic Acceptance and the Montreal Trust Company as trustee, and contained terms which were substantially similar to those found in the separate contracts of an earlier date, providing that subordinated debt should not exceed 150% of the sum of consolidated net worth, calculated in the way already described, and of any subordinated debt junior to what was thereby created. Junior subordinated notes did not exist until July 15, 1964, on which date a trust deed was executed by the same parties relating to them. The limitation on junior subordinated debt was 100% of consolidated net worth. Both these instruments provided that a breach of the ratios affecting them constituted an immediate event of default whereby all the notes became payable at the option of the trustee, without any allowance of time for curing it, whether it arose from a shortage of consolidated net worth or not. By the terms of the deed of trust securing senior notes an event of default in respect of any note, including those ranking below the senior notes, constituted default in respect of all the senior notes as well, so that every penny of Atlantic debt would fall due immediately if the company allowed the subordinated or junior subordinated debt to exceed the ratios permitted in the case of either. Both the subordinated and junior subordinated trust deeds provided, in their turn, that default on payment of interest or principal of a senior note constituted default in respect of the debt secured under their respective terms.

### The Position of C. P. Morgan in February 1961

Before proceeding to observe in some detail the manner in which Atlantic Acceptance complied with the important covenants of the deeds of trust and thus discharged its duty to the holders of its secured obligations, a brief review should be attempted of the company's real position, fully known only to the Trio of Morgan, Walton and Wagman, as it existed on the eve of the company's entry into the money market, culled from material which has been considered in more detail in previous chapters of this report. The execution of the first trust deed was a milestone in the history of the company, as important as the Lambert & Co. loan of $300,000 in 1955, and the Pension Fund's purchase of subordinated notes in 1959. It lifted Atlantic at once to the ranks of those borrowers who could issue notes of varying term, secured in a convenient and acceptable manner by covenants entered into with one of the country's leading trust companies. In a regular and conventional situation the directors and management of any finance company would have had reason for deep satisfaction at such a turn of events. In the

case of Atlantic the satisfaction was present but the company's affairs were neither regular nor conventional. By February 6, 1961 it was deeply involved, by the deliberate choice of its president, in the affairs of Aurora Leasing Corporation and Commodore Sales Acceptance which ensured its collapse over four years later, although at this point its downward course might have been arrested if its real losses, as opposed to its apparent profits, had been resolutely faced and its ultimate stability assured.

At the end of 1960 Commodore Sales Acceptance owed Atlantic approximately $2,000,000 and had lent that money in large amounts to such borrowers as Aurora Leasing ($207,000), Pro Musica ($388,200), American-Marsh Pumps ($111,644), Commodore Portable Typewriter ($789,270), Canada Motor Products ($117,700), Canadian Nevil Enterprises ($189,475) and other debtors equally unlikely to pay.[1] Aurora Leasing had lent the money borrowed from Commodore Sales Acceptance, together with much of its own, to Valley Music Company ($476,000), N.G.K. Investments ($256,125) and G.B.S. Barbecues ($88,500).[2] It is obvious now, and it must have been obvious then to C. P. Morgan that there was no possibility of collecting such sums from Valley Music Company for example, or from Canada Motor Products, or Pro Musica, and Commodore Sales Acceptance could not repay Atlantic unless such debts were collected. As already observed and as will be seen in the next chapter, Atlantic's allowance for bad debts was consistently understated through the personal intervention of Morgan, who regarded it as a device adjustable to the requirement of setting out an attractive financial statement, and at this time it would have been quite insufficient to help the company avoid the consequences of these improvident loans. An additional allowance of at least $550,000, or about one-third of the loan to Commodore Sales Acceptance outstanding at this time, was clearly required to provide for losses which an honest appraisal would regard as being inevitable. Indeed, at the beginning of 1961 the raids of the Trio upon the assets of Atlantic Acceptance in relation to the notes of Aurora Leasing given to Valley Music and the affairs of Commodore Portable Typewriter and other companies which have been described, probably did not exceed $300,000, a sum well within their ability to repay. Minds which conceived the complex schemes by which that money had been surreptitiously extracted from Atlantic would have had little trouble in devising one to return it without arousing comment, had they been bent in that direction. An increase in the bad debt allowance of an additional $250,000 would have left the company well within the required ratios relating to the subordinated debt at the end of 1960 and this could have been attributed by Morgan to the unfortunate loans to Valley Music

[1] Table 11.
[2] Table 20.

many of which were originally made directly by Atlantic Acceptance itself. If a determined effort to collect all but $550,000 of the money owed to it by Commodore Sales Acceptance had failed, the allowance for bad debts could have been again increased in the following year.

Nevertheless the effect of increasing the allowance for bad debts would have had immediate results which Morgan and his associates were not prepared to contemplate. They were at the time mostly engaged in the disgraceful transaction whereby Atlantic Acceptance was made to acquire the minority interest in Commodore Sales Acceptance, which has been described in Chapter V, and the effect of increasing the allowance in Commodore Sales Acceptance by even $250,000 would have been to compel the reporting of a loss, a ratable share of which would have been borne by the holders of that interest and would have compelled the abandonment of the plan to have the parent company purchase their shares and convertible debentures at a substantial profit to themselves. But the long-term benefit of holding their hand at this climactic period was undeniable. Instead of Atlantic reporting a profit of $270,000 at December 31, 1960, as compared with $153,000 at the end of 1949, the more modest figure of some $160,000 could have been adopted; this might have had a depressing effect upon the market value of the company's common shares, but would not have resulted in a serious set-back. Such a pause in the annual rise of profit could hardly have caused apprehension among the existing lenders of short-term money, most of whom had confidence in Lambert & Co. and C. P. Morgan, or could have made it impossible for the company to continue borrowing on a modest scale upon secured notes which ranked ahead of the impressive subordinated long-term commitment of the United States Steel Pension Fund. If entry into the short-term money market had been delayed for some two years as a result of realistic and prudent action at this time, the affairs of Atlantic might well have been arranged so that the detailed reports required under a deed of trust could have been made truthfully when the time came, and the legitimate finance business, tenuous as it was, strengthened both in quality and management in the interim. In short, on the eve of assuming the burdens of the deed of trust, Morgan was still able to choose between ensuring the existence of his company as a stable, moderately profitable concern, of medium size, or embarking upon the course of aggrandizement and deceit during which the spectres of ruin and disgrace were always at his elbow. For example, a loan of $2,000,000 to Commodore Sales Acceptance, on the bulk of which interest would not be received unless the subsidiary company increased its loans to its debtors to enable them to pay, using Atlantic's money to do so, contained a large element of bad debt which must continue to grow, with interest compounded annually, even if Atlantic ceased to support its subsidiary in other equally imprudent ventures. Once the company entered the short-term money

market and borrowed, as it did, to the limit of the permitted ratios, using its bank lines of credit not as a reserve but as working capital, it no longer could do other than conceal its losses. At the first hint of trouble the commercial paper, much of which was payable on demand, must take flight, and default on one note was default on all; under no circumstances could Morgan allow a receiver, with the assistance of independent auditors, to look into his company's affairs. Instead, Atlantic must, through its subsidiaries, plunge into ventures of great risk, apparently in the hope that one or more of them would return a large profit and enable all losses to be made good; of these the prodigal investments in the London complex, which it was intended to sell to the public, in Lucayan Beach Hotel and Development and in Dalite Corporation (Canada) are examples, and to the need for a successful gamble was added the zest of immediate personal gain by the Trio.

The decision to gamble once taken in the hope of halting the rising tide of losses, Atlantic's need for money to finance it became more than ever insistent. Under the provisions of the deed of trust notes on which payment was in default could not be pledged, and new loans had to be made, in larger amounts, to the least reliable debtors, so that the interest could be paid. Since this type of debtor consistently lost large and sometimes immense sums of money in its operations, Atlantic had also to find money to make good these losses and keep it in business. If, for example, Dalite Corporation had been declared bankrupt at the end of 1964, its loan from Commodore Sales Acceptance of over $7,000,000 and the paltry value of its assets as established by the trustee in bankruptcy, not to mention Morgan's personal 25% interest in them, would have been nakedly revealed. It was not unusual for Atlantic to have outstanding some $15,000,000 of notes payable on demand and no unused bank credit or liquid assets to meet the demands which would surely have followed such a disclosure and caused immediate default. Nor do these considerations exhaust the catalogue of dilemmas with which the company was confronted; because it needed increasingly large sums of money to solve the problems which they presented, quite apart from the needs of its legitimate business which, particularly in the last two years of its existence, it was recklessly expanding, it constantly faced difficulty in meeting the requirement that senior debt not exceed 350% of debt subordinate to it, plus consolidated net worth. It was never easy to sell subordinated notes and still harder to sell those in the junior subordinated category. The original trust deed securing subordinated notes, for instance, provided by section 6.10(1), in addition to the 150% limitation, that no subordinated debt could be created unless the earnings of the company exceeded three times what was required to pay the interest on the existing subordinated debt. This, according to the evidence of Davidson, in early 1965 came as an unpleasant shock to Morgan when it was drawn to his attention by Gairdner & Co., who had

been asked to undertake the sale of $3,000,000 additional subordinated notes, after Royal Securities Corporation, which had sold $4,500,000 worth in the previous year, had declined to act any further on Atlantic's behalf.[3] The sale of shares was free of such restrictions, had the effect of increasing consolidated net worth and followed easily upon reports of increased earnings. These earnings could be artificially created by Atlantic's Adelaide Street subsidiaries charging excessive rates of interest to their virtually insolvent debtors and to which they lent the money to pay it. The plight of these debtors has already been described; D.H.I. Limited, as an example, owed Commodore Sales Acceptance almost $4,000,000 at the end of 1964 and was paying interest at rates ranging from 16% to 18%. If that enterprise of Mastino Della Scala had been the most successful in its field, it could scarcely have earned interest at such rates upon such a loan, let alone reduce its principal amount. The bitter complaint of the manager of American-Marsh Pumps, another hopelessly encumbered debtor, has been described in Chapter XIV. So Morgan, having elected not to turn back from the path on which he had embarked at the end of 1960, but to start borrowing in the short-term money market on a large scale, without putting the affairs of Atlantic in order, was forced so to conduct its affairs that, notwithstanding all the requirements of the deed of trust to disclose to lenders its financial condition, the company would maintain the appearance of stability for the benefit of existing lenders and the edification of those with fresh money to lend.

### The Process of Pledging Receivables

Before looking more closely at the devices used by C. P. Morgan to conceal from lenders what lay beneath the imposing façade of the conventional finance business of Atlantic Acceptance, the mechanical process of pledging finance receivables under the senior deed of trust should be explained as Mr. James described it in his evidence.[1] Section 3.01 provided that the receivables which the company mortgaged, pledged and charged, by way of a first fixed and specific mortgage in favour of the trustee, should be delivered to it, or to a depositary designated by it. Section 18.01(4) provided that the trustee could select any bank as a depositary for them. On February 8, 1961 the Montreal Trust Company designated the Colborne and Dundas Streets branch of the Toronto-Dominion Bank in Oakville,[2] and thenceforward this branch acted as sole depositary for all the notes, accounts receivable and conditional sales contracts and other commercial paper pledged by the company with the trustee, except, if Davidson's recollection is not at fault, at least some of those originating with the Premier Finance

[3]Evidence Volume 79.
[1]Evidence Volume 75.
[2]Exhibit 3443.

Corporation which were somewhat surprisingly lodged with C. F. O'Neill, as agent for the Montreal Trust Company and the Toronto-Dominion Bank. Mr. James selected, as an example, a promissory note numbered MPS1, dated January 18, 1965, and made payable to Commodore Factors Limited by Motion Picture Security Corporation for the sum of $50,000 in U.S. funds,[3] a copy of which was obtained from the Toronto-Dominion Bank in Oakville. Commodore Factors endorsed this note in favour of Atlantic Acceptance Corporation which in turn endorsed it as payable to the order of the Montreal Trust Company; it was then lodged with the depositary accompanied by a "collateral deposit form", dated March 31, 1965, as one of a series of forty notes, each for $50,000 in U.S. funds, with an aggregate face value of $2,000,000, under the category of "Finance Receivables arising out of the financing of commercial equipment and installations", the form being as prescribed by the fourth schedule of the senior trust deed.[4] The deposit form is signed by A. G. Woolfrey for Commodore Factors, pursuant to an "Inter-Company Loan Agreement" between Atlantic Acceptance Corporation and Commodore Sales Acceptance, dated February 7, 1961[5], in which Commodore Sales Acceptance undertook for itself and its subsidiary company, Commodore Factors, to assign to Atlantic as security any instruments of debt received by it as a result of lending money which it had borrowed from Atlantic. A similar agreement was entered into between Atlantic and Adelaide Acceptance, dated June 1, 1962,[6] and the effect of both of them was to make all the receivables of the subsidiary companies available for pledging under the terms of the deed of trust.

The details of this collateral deposit form numbered 974 were then transferred to a "master" collateral deposit form, containing those of collateral deposit forms 969 to 974 inclusive and also dated March 31, 1965,[7] signed for Atlantic Acceptance by Donovan R. Lytle, the company's assistant treasurer in Oakville, and directed to the depositary to lodge the constituent deposit forms with their accompanying notes, a copy of which was forwarded to the trustee by the bank. Some variations of this procedure occurred when a subsidiary company, with a large number of receivables to assign, would make out the master collateral deposit form itself, or as a result of the introduction of electronic data processing equipment at Oakville in November 1963, when the records produced by this equipment might be substituted for the individual collateral deposit form. The depositary, in accordance with the terms of the deed of trust, kept records showing a running total of the face value of all the securities and notes lodged with it, and in this

[3]Exhibit 3444.
[4]Exhibit 3445.
[5]Exhibit 3446.
[6]Exhibit 3447.
[7]Exhibit 3448.

case the total of the Motion Picture Security notes of $2,114,587.64 were shown as having been deposited on a ledger card of the Toronto-Dominion Bank entitled "Commodore Sales Acceptance".[8] The depositary was obliged to deliver to the trustee a monthly certificate as to the face value of the finance receivables deposited with it,[9] and the Motion Picture Security notes were in due course included in its April report as to receivables of Commodore Sales Acceptance deposited in the amount of $38,596,475.55. The trustee was entitled under the trust deed to rely upon the depositary's certificate, as it was upon the monthly report made to it by the company of the actual amount outstanding of the pledged receivables, prepared in the form prescribed by the Third Schedule to the trust deed. Since however payments were constantly being received by the company to reduce the face amount of the receivables pledged, and the depositary was only bound to report such face amount to the trustee until the receivables lodged with it were completely paid and withdrawn, it was one of the duties of the trustee to ascertain that at all times the face value of the receivables lodged with the depositary exceeded the amounts reported monthly as pledged in the Third Schedule.

In the case of those pledged receivables which were not re-negotiated but paid out, a similarly documented process of withdrawal from pledge was carried out between the company, the trustee and the depositary. No notes or other evidence of debt which had been pledged were permitted to leave the care of the depositary until the trustee had signed a form of release[10] which reassigned them to the company. Such a release was obtainable, on the requisition of the company, in the shape of a master collateral withdrawal form to list the receivables for which release was sought.[11] Here again the trustee was entitled to rely upon the representations of the company under the terms of the trust deed, and his duties were confined to checking the sum represented by the receivables on the withdrawal form to make sure that the permitted ratio of pledge was maintained and the security not imperilled. Once satisfied as to this, the trustee re-endorsed the notes back to the company, signed the release form and sent it to the depositary which, having posted the total to its collateral control cards, delivered the specified receivables to the company and obtained a receipt for them. At the time under examination, and in relation to notes being pledged through all the offices of Atlantic Acceptance and its subsidiary companies, the repetition of this process occurred some 8,000 times a month with a corresponding volume of withdrawals; the considerable size of the clerical operation involved, as performed by trustee and depositary for a modest

[8]Exhibit 3449.
[9]Exhibit 3450.
[10]Exhibit 3451.
[11]Exhibit 3452.

remuneration, was not overwhelming, but will become of significance when the time comes to consider legislative changes at present contemplated in Ontario.

### The Specific Charge: 115% of Senior Debt Outstanding

The reason for this elaborate procedure, laid down by the provisions of the deed of trust, is to be found in the terms of one of its most important covenants. By paragraph (A) of section 6.12(1), under the heading "Maintenance of Security", the company undertook to pledge with the trustee, as property specifically charged, finance receivables or cash (for which Government of Canada bonds might, upon application, be substituted) in the principal amount of not less than 115% of the principal amount of all senior debt at the time outstanding, or a combination of receivables plus cash and bonds of the same value. In practice Atlantic never pledged any cash or bonds with the trustee and the whole of the property subject to the specific charge was invariably promissory notes and accounts receivable. Since the lenders evidently intended that no unreasonable concentration of loans made to a few borrowers should be included in their security, this paragraph also provided that not more than 20% of the amount of the pledged receivables should consist of any having an original principal amount of more than U.S. or Canadian $15,000 each, and that at least 50% of the principal amount of the receivables pledged be derived from the financing of automobiles, consumer appliances, soft goods, accounts receivable or inventories, or the making of personal loans. Then again, the pledged receivables must not include any delinquent accounts or any "Re-pledge Deficiency", defined in paragraph (D) of the subsection as the excess of any receivables pledged by a subsidiary of Atlantic over what it actually owed to the parent company which, in the event of the bankruptcy of such a subsidiary, would have been returnable to its estate after the parent company's debt had been satisfied. The essential and most indigestible proviso, as far as Morgan was concerned, was the limitation of $15,000 upon the amount that any one receivable could represent in 80% of the total pledged, and he was quick to detect a flaw in this restriction which would enable Atlantic to comply with the letter, if not the spirit of its language.

The definition of "receivables", contained in section 1.01 of the senior trust deed, is "any promissory note, draft, participation note or other instrument or order for the payment of money, or any other obligation for the payment of money, or any conditional sales contract or any account receivable". It is clear, then, from reading paragraph (A) of section 6.12(1), set out at length in Appendix K, that for "receivables" may be read "promissory notes", and that the relevant portion of the restrictions therein imposed can read "not more than 20%

in principal amount . . . shall consist of promissory notes *each* having an original principal amount of more than . . . $15,000". As so often seen, Atlantic Acceptance, in the person of C. P. Morgan sitting at the centre of the operations of the Adelaide Street subsidiaries, cared nothing for the obvious rule of prudence that a finance company should spread its risk by having by far the preponderant part of its receivables owing in small amounts by many debtors, so that no mere one or two defaults could result in serious loss. These subsidiaries, under his absolute and unquestioned control, commonly loaned hundreds of thousands and even millions of dollars to each of a very few debtors. He needed these receivables, particularly in 1964 and 1965, for pledging by Atlantic to meet its obligation to have on deposit 115% of the senior debt. Accordingly he arranged to obtain from these debtors to whom large sums had been lent a number of promissory notes each for $15,000 which, in the aggregate, represented the total amount of much larger loans, and pledged them with the trustee, confident that in this respect Atlantic was not technically in breach of the restriction which it had covenanted to observe. There is no evidence, and indeed it is unlikely, that counsel's opinion was sought; if it had been it is fair to assume that any member of the firm of Osler, Hoskin & Harcourt would have advised that, although a strict interpretation of the trust deed would justify the adoption of such a device, it was clearly hostile to the intention of this provision and should not be resorted to, at least without the consent of other parties interested. Needless to say such consent was never sought from the lenders or from the trustee and there is no evidence before the Commission that the trustee, which was in a position to observe the practical application of Morgan's ingenuity, made any protest to the company.

Two examples of this evasion of the manifest intention of the deed of trust may suffice. The depositary's collateral ledger showed as pledged forty promissory notes, each for $15,000, made in favour of Adelaide Acceptance by Frederick's Department Store, as evidence of a loan of $600,000 secured by a floating charge debenture,[1] in circumstances more fully described in Chapter VII. This debt was never paid, although expressed in the debenture as payable on April 30, 1964. The notes were never deducted and remained pledged, and unreported as delinquent, in the monthly Third Schedule reports thereafter until the day of default. By December 31, 1964 Aurora Leasing Corporation had given notes to Commodore Sales Acceptance, as evidence of debt to that company and its subsidiary Commodore Factors, of $7,335,000 out of a total approaching $10,000,000 in Canadian funds. There were 475 of these notes in amounts of $15,000 or less, only a fraction representing more, and they were all lodged with the depositary as security under

[1]Exhibit 1432.

the deed of trust. The limitation on the amount of receivables, each representing a principal amount of more than $15,000, which could be pledged as specifically charged, whether the position taken by Atlantic was or was not justifiable, was exceeded at August 31, 1964 by $5,777,-000, at September 30 by $5,372,000 and at December 31 by $3,021,-000.[2] Although, as has been said, Atlantic probably acted lawfully upon a strict interpretation of this section of the deed of trust, it failed to show the good faith which accepted standards of business practice require. The lesson to be learned from this is that lenders and their lawyers who prepare deeds of trust must take care to say what they mean, even if this involves saying more than they think is necessary.

**Delinquent Accounts**

Only "finance receivables", defined in section 1.01 of the senior trust deed, could be pledged with the trustee as security for the notes issued thereunder and the definition of these provided that any receivable taken in payment of delinquent interest must be excluded. For the purposes of calculating 115% of the outstanding senior debt a further limitation was imposed by section 6.12(1)(A), requiring the deduction of any "delinquent accounts included therein", and a further reference to section 1.01 must be made for a definition of "delinquent accounts".

> " 'Delinquent Accounts' means as at any time the sum of the following items (1), (2) and (3):
>
> (1) The full unpaid amount of Receivables (other than loans made under the Small Loans Act of Canada [herein called 'small loans']) on which any installment of principal or interest is 60 days or more overdue;
>
> (2) The full unpaid amount of small loans on which no collections have been received for 60 days or more; and
>
> (3) The full unpaid amount of small loans on which interest and charges only were received in the last 60 days."

The monthly report which the company was bound to make to the trustee, the form of which was provided in the Third Schedule, required the company to show what deduction should be made from the total amount of pledged receivables for delinquent accounts. Atlantic Acceptance always reported that there was no deduction to be made. In view of what has been established in preceding chapters of this report as to the record of prepayment of principal on the loans made by the Adelaide Street subsidiaries, these reports require additional and perhaps repetitive comment. Repayment of principal was rare indeed, except when the identity of the borrower was changed from

[2]Exhibit 3462.

one company in which Morgan and his friends had an interest to another; yet, at the end of 1964, approximately $30,000,000 of receivables from the Adelaide Street companies were pledged[1] and not one was ever said to be delinquent. The approach of Atlantic to this problem was simple; in almost every case evidence of the loans made by these subsidiaries were promissory notes payable on demand and they never demanded payment, even in circumstances of the most flagrant delinquency. Thus the pettifogging insistence on the letter of the deeds of trust, with which they treated, where possible, all their restrictions and limitations, enabled the subsidiaries to report to the parent company, which in turn reported to the trustee, that none of the receivables pledged were delinquent accounts. The notes of Frederick's Department Store given to Adelaide Acceptance for its loan of $600,000 were demand notes, even though the debenture securing them expressed the debt to be due on April 30, 1964. Nothing was ever paid on them on account of principal and Frederick's went out of business in 1964 clearly insolvent; yet Adelaide Acceptance never demanded payment and could literally maintain that no principal need be described as overdue. If such a view of the relevant provisions of the deed of trust were to be seriously advanced, it would be necessary to overlook other provisions, and in particular that of section 6.01 which required the company to "diligently maintain . . . the mortgaged property and the property of its subsidiaries and . . . cause to be carried on and conducted the business of its subsidiaries in a proper and efficient manner so as to preserve and protect the mortgaged property". To refrain from demanding payment from Frederick's in 1964, and realizing on at least part of the security, was certainly a breach of this convenant, but is only one of many examples of how the obligation was ignored day after day.

The restriction upon the constitution of "finance receivables" which required the exclusion of any portion taken in payment of delinquent interest was fundamental to any agreement with lenders to a finance company, who well knew that, if its lending policies had been reckless and had created a risk of serious loss, it might create a false impression of profit by making it appear that all its borrowers were faithfully paying their interest by lending them the money with which to pay it, or "capitalizing" it in the sense that the amount in arrears would be added to the principal amount of a loan and treated as paid. This practice was the rule, rather than the exception, in the operation of the Adelaide Street companies, although it is fair to say that, in providing for its exclusion in the definition of finance receivables, lenders did not contemplate that any company would be so foolish as to pursue a policy of capitalizing interest deliberately and on a large scale. Any finance company may choose to treat as principal the unpaid interest on a loan

[1]Exhibit 3460.

outstanding at the end of the year for reasons of internal administrative convenience, and the deed of trust therefore required that the extent to which this choice had been made should be disclosed. Nevertheless Atlantic Acceptance never reported any deduction of delinquent interest included in the principal owing on a pledged receivable and there was no procedure established in any of the trust deeds to reveal the extent to which delinquent interest was being capitalized. Lenders relied on the company honestly reporting monthly on its finance receivables, as defined, as it covenanted to do. In this respect alone the reports filed with the trustee by Atlantic Acceptance, during the whole life of the deed of trust, were false, in that the amount owing on finance receivables pledged always included delinquent interest on some notes as principal and this was never deducted.

**Limitation on Pledged Receivables of Any One Obligor**

As already seen, the purchasers of the Series "J" senior notes imposed additional restrictions on Atlantic Acceptance under the fourth supplemental indenture dated June 8, 1962. One of these, which struck hard at the type of business conducted by the Adelaide Street subsidiaries and was thereafter added to section 6.12(1) of the original deed of trust, was a provision that the pledged finance receivables "shall not at any time include Receivables in respect of any single obligor (other than a Subsidiary) in an aggregate principal amount exceeding (i) U.S. or Canadian $500,000, or (ii) 20% of Consolidated Net Worth at such time whichever is smaller; provided that Finance Receivables upon which an obligor is only contingently liable shall not be deemed to be Finance Receivables in respect of such obligor for purposes of this sentence". The proviso was intended, no doubt, to permit the company to lodge conditional sales contracts relating, for example, to automobiles purchased by a large number of individuals from one dealer, in respect of which the company was given recourse against the dealer only if a purchaser failed to make payments called for by the contract. The primary debtor was the purchaser, and the dealer would be liable to Atlantic only if he failed to pay and realization of the security left a balance owing to it. Although all these notes included the dealer as an obligor, he was only contingently liable, and, under the proviso, notes which in the aggregate might exceed $500,000 could still be pledged.

This awkwardly-worded addition to section 6.12(1)(A) leaves much to be desired, particularly in respect of the proviso, and may have been simply lifted from another indenture where it had done better service. Atlantic Acceptance, through its subsidiaries, had sums owing to it greatly in excess of $500,000 by single obligors, pledged them with the trustee and reported to it monthly, in the form prescribed by the Third Schedule, that "no default exists in the performance of the

covenants of section 6.12(1)" and, at December 31 in each year after the execution of the fourth supplemental indenture on June 8, 1962, reported, as required by the amendments therein introduced, that "the largest aggregate principal amount of Finance Receivables so pledged in respect of any single obligor (other than a Subsidiary) does not exceed \$500,000". This statement was false, as will be demonstrated, but first of all the company's interpretation of this restriction must be examined before determining the extent to which falsification was deliberately resorted to.

It has already been seen that by December 31, 1964 Atlantic had lodged, as pledged receivables, promissory notes signed by Aurora Leasing in favour of Commodore Sales Acceptance in the amount of \$7,335,000. In discussions with Mr. James, A. G. Woolfrey, Morgan's executant for both Commodore Sales Acceptance and Commodore Factors, claimed that Atlantic considered these could be lodged because they were not obligations of a single obligor, in that Aurora had assigned to Commodore Sales Acceptance as security notes received from debtors to which it had lent money borrowed from that company, and these notes represented obligations of the debtors as well as Aurora. This position is, of course, completely untenable, since the notes lodged as pledged receivables were themselves made by Aurora, and by it alone, and Aurora was the only debtor liable. The notes received by Aurora from its debtors were not in fact lodged, although ostensibly assigned by it under the questionable assignment of book debts of December 1960, now under attack because of Carl M. Solomon's failure to provide an affidavit of *bona fides* executed by the proper party. Aurora was not a subsidiary of Atlantic, or of any of the Atlantic companies, and did not fall under the exception to the \$500,000 limitation in that respect; nor had any notice of assignment ever been given by Aurora to any of its own debtors and it was itself the maker of the only notes pledged. It was not objectionable to pledge notes made to Commodore Sales Acceptance by different debtors, no one of whom owed more than \$500,000, merely because that company assigned them to Atlantic, but it was forbidden to lodge as pledged receivables notes made by one debtor totalling more than \$500,000, even when Commodore Sales Acceptance had assigned them to the parent company to enable them to be pledged. Moreover, if it had been possible for Atlantic to resort to the loans made by Aurora with the money borrowed from Commodore Sales Acceptance in applying a test to discover whether any breach of this limitation had occurred—and clearly this was not the case—few of Aurora's outstanding receivables would have qualified at the end of 1964. It had eleven loans outstanding in excess of \$500,-000, amounting in the aggregate to \$10,866,153,[1] and evidently the

[1]Exhibit 3455.

only reason for their not all being pledged was that a loan of $2,075,-000 had been made to Evermac Office Equipment Company to enable Jack Tramiel to purchase 80% of the shares of Hugo Oppenheim und Sohn, and there was not even a promissory note to serve as evidence of that debt.

Commodore Sales Acceptance and Commodore Factors made another type of loan which Atlantic Acceptance, with more reason, contended was excluded from the prohibition against lodging debt of a single obligor in excess of $500,000. These were loans to debtors made in the course of factoring their accounts receivable, an example of which has already been considered in some detail in Chapter XII dealing with the affairs of the Nevil group of companies. It will be recalled that Nevil Plastics Inc., and later Nevil Enterprises Inc., borrowed from Commodore Factors the amounts of money owed them by their customers, subject to discount in favour of the lender, and assigned their customer's receivables individually to it as security for the debt. The form of the agreement[2] which Commodore Sales Acceptance entered into with factoring borrowers provided for the outright purchase of the accounts receivable and their sale back, or assignment, within 90 days of their having fallen into default as notified by the lender. This form of agreement, indeed, stipulated that borrowers should notify those customers whose receivables were assigned of the fact that they were being factored and with whom, but Woolfrey's evidence about the practice of Commodore Factors, particularly in the case of the Nevil companies, was that all the assignments were made on a "non-notification basis" and that in every case use was made of a transfer account into which payments were made ostensibly to Nevil Enterprises, for instance, and transferred automatically to Commodore Factors through the medium of the account. This method of transferring payments was designed specifically to conceal from the customers of Nevil Enterprises that their payments were in fact being made to Commodore Factors and, if Woolfrey's recollection is accurate, all the customers of Commodore Factors were treated in this way. The distinction is of some importance in law, since Atlantic contended that Nevil Enterprises was only contingently liable and that, even though the aggregate owing by it exceeded $500,000, these receivables could be pledged under the exception provided in the addendum to section 6.12(1). It is probable that the lenders to Atlantic under the fourth supplemental indenture intended factored receivables to be pledged free from any limitation, provided that notice was given to its own debtors of the assignment by the borrower from the Atlantic companies, thus making them primarily liable. It is also probable that the "non-notification" procedure was objectionable, because without notification of the assignment these debtors could not be considered as

[2]Exhibit 3456.

primarily liable. Needless to say in the case of the Nevil companies, failure to notify was not dictated so much by any desire to preserve their reputation with their customers as it was to conceal from the latter the fact that fictitious receivables were being assigned to Commodore Factors and duly pledged under the deed of trust.

In any event Mr. James, in his review of Atlantic's compliance with the deed of trust, under this limitation gave the company the benefit of the doubt, and also made a separate calculation conceding Woolfrey's contention that the Aurora Leasing notes and similar receivables could be properly pledged which was clearly not the case. His calculations submitted in evidence were as follows:[3]

SECTION 6.12(1)

(The pledged receivables shall not include any for a single obligor except a subsidiary, in an aggregate principal amount exceeding $500,000. Where the obligor is contingently liable the receivables are not to be included in this limitation.)

*Non-admissible receivables—obligors exceeding $500,000*

| | 1964 | | |
|---|---|---|---|
| | *August 31* | *September 30* | *December 31* |
| From a scrutiny of the receivables pledged, the maximum aggregate amount of all obligors exceeding $500,000 is, per obligor: | | | |
| Commodore Sales | $16,661,120 | $17,294,870 | $16,658,844 |
| Commodore Factors | 2,227,266 | 2,377,273 | 1,734,387 |
| Adelaide | 2,565,750 | 2,534,625 | 1,775,750 |
| | $21,454,136 | $22,206,768 | $20,168,981 |
| Based on the interpretation of the Trust Indenture, where the factoring of accounts receivable is to be excluded, the figures become | | | |
| Commodore Sales | $12,772,514 | $12,772,514 | $12,774,865 |
| Commodore Factors | 1,056,947 | 1,056,947 | 1,100,920 |
| Adelaide | 2,565,750 | 2,534,625 | 1,775,750 |
| | $16,395,211 | $16,364,086 | $15,651,535 |
| Say | $16,395,000 | $16,364,000 | $15,651,000 |
| However Mr. Woolfrey contended that from these figures the notes receivable and rediscounted notes should be excluded i.e. | | | |
| Commodore Sales | $ 4,957,444 | $ 4,957,444 | $ 4,959,795 |
| Commodore Factors | 1,056,947 | 1,056,947 | 1,100,920 |
| Adelaide | 2,565,750 | 2,534,625 | 1,775,750 |
| | $ 8,580,141 | $ 8,549,016 | $ 7,836,465 |

It will be seen that at the ends of the months of August, September, and December 1964, even if Woolfrey's contentions were accepted, Atlantic had pledged approximately $8,000,000 of prohibited receivables, whereas it had reported specifically to the trustee that on December 31 it had none over $500,000; if it is conceded, as it must be, that Woolfrey was wrong, the excess over the prescribed limit at each date amounted to an average of $16,000,000. Some detail of the figures in the case of Com-

[3]Exhibit 3455.

modore Sales Acceptance, with the comparative figures based upon acceptance of the validity of pledging the factored receivables, and of Woolfrey's interpretation, were also provided:

*Obligors exceeding $500,000*
e.g. Pledged receivables of such obligors of
Commodore Sales Acceptance as at August 31, 1964.

(Balances extracted from the records of the above company).

| | *Single Obligors Exceeding $500,000 Each* | | *Figures Excluding Factored Receivables* | *Mr. Woolfrey's Interpretation* |
|---|---|---|---|---|
| 1. American-Marsh Pumps | | | | |
| Accounts receivable....... | $ 95,360 | | — | |
| Notes operating account... | 339,479 | | $ 525,979 | $ 525,979 |
| Instalment notes.......... | 186,500 | | | |
| | | $ 621,339 | | |
| 2. Aurora Leasing | | | | |
| Rediscounted notes........ | | 7,335,000 | 7,335,000 | |
| 3. Dalite Corporation | | | | |
| Accounts receivable....... | 2,483,454 | | 1,700,000 | |
| Inventory loans........... | 2,516,996 | | 2,516,996 | |
| | | 5,000,450 | | 4,216,996 |
| 4. Daylite of Grand Bahama | | | | |
| Instalment notes.......... | | 900,000 | 900,000 | 900,000 |
| 5. D. H. I. | | | | |
| Accounts receivable....... | 3,484,404 | | | |
| Instalment notes.......... | 25,388 | | — | |
| | | 3,509,792 | | |
| 6. Pro Musica | | | | |
| Inventory loan............ | 510,569 | | | |
| Instalment notes.......... | 432,000 | | | |
| Notes—operating account.. | 371,900 | | | |
| | | 1,314,469 | 1,314,469 | 1,314,469 |
| 7. Ticonderoga Investments | | | | |
| Notes receivable.......... | | 704,462 | 704,462 | |
| 6. Trans Commercial Acceptance | | | | |
| Rediscounted notes........ | | 1,019,562 | 1,019,562 | |
| 9. Briardale Investments | | | | |
| Notes receivable.......... | | 756,046 | 756,046 | |
| | | 21,161,120 | 16,772,514 | 6,957,444 |
| Less $500,000 permitted per obligor............... | | 4,500,000 | 4,000,000 | 2,000,000 |
| | | $16,661,120 | $12,772,514 | $4,957,444 |

There is no reason to doubt that detailed calculation at any other date during the life of this restriction in the deed of trust would have disclosed, in this respect, a breach of section 6.12(1) in the teeth of the monthly disclaimer reported to the trustee.

## Reports to the Trustee and the Noteholders

It is now generally agreed, in the latter-day enthusiasm for disclosure of their affairs by public companies, that the amount of information given to lenders and the public generally by Canadian finance companies was inadequate prior to 1965. Certainly, compared with what is now

poured out in prospectuses and annual reports, this criticism is justified. However, as Mr. Abell found when compiling his report, Atlantic Acceptance was generally regarded in the United States, from which much of its funds were drawn, as more forthcoming with information than most of its competitors. Indeed, since American lenders were in a position to compel the disclosure of such information as they required through agreements concluded with the company in the case of notes purchased before the execution of the original deed of trust and its successors, and by the terms of those instruments thereafter, there was little ground for complaint as to its volume and frequency. The condemnation of Atlantic Acceptance, and in particular its president, C. P. Morgan, whose word was law to the head offices in Oakville, which he visited only some three or four times a year, proceeds from more serious offences than a merely grudging disinclination to expose the secrets of the company's business and financial condition. Morgan did resort to concealment from time to time under the guise of merely neglecting to comply with the requirements of the deeds of trust, and was encouraged to do so because no complaints were ever apparently made; but more often, and indeed consistently during the period when these instruments of security were in force, Atlantic Acceptance under his direction deliberately gave information which was false. It is appropriate to mention here, briefly and in one place, the reports which were required and the responsibility of those employees of the company who prepared them.

The reports required by the original trust deeds securing the three categories of notes and the deeds supplemental to them may be summarized as follows:

1. A monthly report, prescribed, as to form and content in the Third Schedule to the senior trust deed, required by section 6.12 (1)(B) to be delivered to the trustee, not less than 30 days after the end of each calendar month, with respect to its compliance with the covenants as to maintenance of security contained in section 6.12(1) (A), relating to the restrictions as to not more than 20% of the finance receivables being each in excess of $15,000, as to not more than 50% of them in principal amount being derived from finance business other than the financing of automobiles, consumer appliances, soft goods, accounts receivable or inventories or the making of personal loans, less deductions of the amount of delinquent accounts and repledge deficiency, and as to pledging at least 115% of the amount of senior debt in the form of receivables, cash or bonds with the depositary as part of the specifically mortgaged property. This was to be accompanied by a certificate of the company's bankers as to the amount owed to them, and by one of the trustees that the face amount of receivables lodged with it was not less than the amount owing upon them as certified by the company.

2. A quarterly report within 60 days of the end of the first three-quarters of the fiscal year, prescribed in section 6.11, providing the trustee with an unaudited consolidated balance sheet and operating statement with figures for the corresponding periods of the previous fiscal year, all "in reasonable detail" and certified by a principal accounting officer of the company.

3. An annual report within 120 days of the end of the fiscal year to include an audited consolidated balance sheet and operating statement of the company, and any detailed report made to it in connection with the annual audit of its books by "independent public accountants", or, as we would say, auditors. Both the quarterly and annual reports were to be accompanied by a certificate of the principal accounting officer of the company to the effect that to the best of his knowledge no condition existed which constituted or, with notice or lapse of time, would constitute an event of default or, if such condition did exist, what action the company proposed to take. With the annual report such a certificate was also required from the company's auditors to the effect that they had obtained no knowledge of the existence during the fiscal period under audit of any condition constituting, or capable of constituting an event of default, or the nature of it if such condition did exist. These reports were to be delivered to the trustee which was obliged to give them to any noteholder requesting them and was entitled to such other financial data as it might reasonably request. In practice lenders, other than holders of short-term notes, received the quarterly and annual reports, but not the monthly report required by the Third Schedule which was not usually asked for by lenders.

4. By the terms of an agreement between Atlantic Acceptance and the Guardian Life Insurance Company of America, dated May 28, 1962,[1] covering the purchase by the latter of $1,000,000 of the Series "J" senior notes secured by the fourth supplemental indenture, a draft of which was attached to it, the company bound itself to supply, within 90 days of the end of its fiscal year, a lengthy report in two parts. The first part was to give detailed information about many aspects of the company's finance business, including the state of its delinquent accounts, its experience of loss and the allowance for losses made in respect of accounts receivable by the company and its subsidiaries. The second part consisted of a completed form described as the Robert Morris Associates Questionnaire. This form, itself divided into two parts, "white" and "yellow", is considered at some length in Chapter XVII.[2] It was widely used in the United States as a requirement by lenders to finance companies and disclosed

[1] Exhibit 3439.
[2] pp. 1432-8.

substantially that which Canadian finance companies now freely disclose, mainly as a result of the disaster which overtook Atlantic Acceptance; one of its questions required an answer disclosing the percentage of unearned interest taken into revenue as the cost of acquisition of a loan contract in which a pre-computed interest charge was included in the principal amount payable, and which Atlantic Acceptance truthfully reported to be 40%. Among other things stipulated by the Guardian Life was the opinion of its counsel, Sullivan & Cromwell, as to the status of Atlantic, the validity of remedies to enforce the security provided by the trust deed, of the registration of this instrument and its qualification with the various regulatory authorities. In giving this opinion Sullivan & Cromwell were entitled to rely on that of Atlantic's solicitors, Osler, Hoskin & Harcourt.

The certificate of the principal accounting officer of Atlantic Acceptance required for the quarterly and annual reports was usually signed by the company's comptroller, P. D. McCaughey, and the monthly reports by Donovan R. Lytle, assistant treasurer since 1962, and C. R. Sherrill, the vice-president and operating head of Atlantic's sales finance business other than that carried on by Atlantic Finance and the other subsidiaries. The report prepared as a result of the agreement with the Guardian Life, which was known as "Supplementary Information", was not signed but was distributed, as far as the commission has been able to ascertain, to most of the noteholders from the time when it was first submitted at the end of 1963. Under the agreement which engendered it the company was allowed a period of grace to assemble the information demanded, and this was first provided at December 31 of that year after installation of electronic data processing equipment without which it could not have been produced. This was an innovation of considerable importance which J. E. Lee,[3] of Wright, Erickson, Lee & Macdonald, Atlantic's auditors up until 1964, said that he had urged upon Morgan for many months. To the trained eye, examining the information provided in the supplementary information report and the Robert Morris Associates Questionnaire, the real worth of Atlantic Acceptance, the prudence of its lending policies and the efficiency of its operation would be apparent, provided always that the information was true. The information about Atlantic Acceptance and Atlantic Finance which was first submitted to analysis by the data processing equipment was true enough. Generally speaking, whatever was supplied about the Adelaide Street subsidiaries was false when it was eventually supplied in 1964; indeed the yellow sheet of the Robert Morris Questionnaire, which would have disclosed details of the Adelaide Street subsidiaries' commercial loans and of any interest which their

[3]Evidence Volume 79.

officers had in companies indebted to them, was never completed and and its absence apparently caused no comment.

Donovan R. Lytle, who testified to the Commission on February 14, 1967,[4] was a former employee of Great Northern Capital Company in Manitoba and was recruited as assistant treasurer of Atlantic by David Davidson, then both secretary and treasurer of the company, in February 1961 to organize the flow of collateral security, in the form of notes and accounts receivable, to be specifically charged under the senior deed of trust executed in that month. His office was situated at Oakville and his duties complemented those of Barrie L. McFadden, also appointed an assistant treasurer and assistant secretary in the same month to superintend the borrowing of funds in the money market and whose office was immediately outside that of C. P. Morgan at 100 Adelaide Street West. Lytle, like McCaughey, the comptroller, was a chartered accountant, and both he and Davidson found themselves at variance with the views of Morgan as to the method of calculating the amount of the senior debt outstanding in accordance with the provisions of the deed of trust. Davidson recalled that when the senior trust deed was signed in February 1961, and he found himself responsible for preparing the information required in the monthly report to the trustee, he raised the matter with Morgan.[5]

> "A. I emphasized to Mr. Morgan the need for planning to comply with that provision and certain other provisions of the trust indenture. That particular provision was perhaps the one that required most additional accounting effort.
>
> Q. Yes?
>
> A. I don't want to short-cut my comment, but I do recall Mr. Morgan making a comment, perhaps jokingly, I will never know, 'these documents you throw out the window and go to work as if they don't exist'. I disputed that.
>
> Q. Let's take one of the documents. Generally, your company was required to prepare a third schedule which was to be filed with the trustee monthly. Did you ever receive copies of the third schedule?
>
> A. Yes.
>
> Q. Was there any difference in the early years and in the later years as to how that schedule was prepared or distributed?
>
> A. In the later years I didn't receive a copy of the third schedule.
>
> Q. What years would these be approximately?
>
> A. Oh, early 1964 and '5.
>
> Q. Prior to that time, you did receive it?
>
> A. Yes.

[4]Evidence Volume 95.
[5]Evidence Volume 79, pp. 10663-5.

Q. Did you have any occasion to make a comment upon it?

A. Yes, I had occasion to object to the manner in which they were prepared.

Q. How did this arise?

A. I took the position that they were not being prepared in conformity with the provisions of the senior trust indenture.

Q. To whom did you express this view?

A. To Messrs. Morgan and McFadden. At that time, McFadden was assistant secretary and assistant treasurer, I believe.

Q. In what respect did you think the returns were improperly prepared?

A. Principally in two main respects. First of all, much of the senior debt of the company was debt which had been raised in the United States and was repayable in United States funds. The senior trust indenture specifically provided the method which was to be followed in evaluating the amount of that debt for the purpose of submitting the so-called third schedule.

Q. You speak of conversion into Canadian funds?

A. Yes, from United States to Canadian funds. I maintained the conversion arithmetically had not been made in conformity with the provisions of the trust indenture and, incidentally, I refused to sign it . . ."

After dealing with another point counsel reverted to the method of calculating the outstanding debt.[6]

"Q. To make clear your first point when you were dealing with the method Morgan adopted for converting American debt into Canadian dollars, you said you objected to the practice. Is the practice you are objecting to that of not converting for delivery but treating United States dollars as being equivalent to Canadian dollars?

A. Oh, the passage of time dulls the memory somewhat. I do know this; that shortly after the senior trust indenture was issued, I personally arranged for the accounting department in Oakville to prepare a supplementary schedule to the senior trust indenture, to the third schedule of the senior trust indenture.

Q. Yes?

A. Showing three sets of figures representing senior debt of the company. One set was at face value. That is a mixture of Canadian and United States funds, depending in which country the funds were obtained.

Q. Making no distinction as far as the exchange is concerned?

A. Yes, forgetting entirely about the exchange. Number two; the United States funds expressed in terms of historical exchange rate. That is the exchange rate in effect at the time the indebtedness was issued.

[6]Evidence Volume 79, pp. 10667-71.

Q. Yes?

A. And three; expressing the United States funds in terms of Canadian dollars at the exchange rate in effect as of the date of the third schedule.

Q. Yes?

A. Now, right this morning I found a little difficulty to recall which one of those three was the proper one for use in preparing the third schedule.

Q. The third one, the current rate?

A. And the third schedule indicated on more than one occasion, had it been prepared in accordance with the provisions of the trust indenture and recognizing the fact that only a minimum of $1,250,000 for all bank borrowings had been reported as senior debt—the indication was that had the third schedule been prepared, in my opinion, based on my interpretation of the third indenture, the amount of collateral on hand with the trustee, the Montreal Trust Company, failed to meet the amount required by the provisions of the trust indenture.

Q. Then do you assert that in your opinion, in the early months after the execution of this trust indenture, the company was calculating this senior debt for the purpose of this third schedule upon a basis which you considered to be not that required by the terms of the indenture and the effect of it was, in your judgment, to understate the aggregate amount of the senior debt?

A. Yes.

Q. What did Mr. Morgan say to your point which you raised?

A. I can't recall exactly, but I fear I walked in where angels feared to tread and in substance, I was told it was none of my business.

Q. Did you continue to receive the third schedule with the calculation upon the three bases?

A. No. That was discontinued. I believe it was prepared. They continued to prepare it, but after a certain period of time—I don't recall how long—for some reason or other—I suppose there is an explanation for it, but if there is, I don't know it, it wasn't supplied to me.

Q. Was this a document for internal use for calculation or something?

A. Purely internal. It wasn't required to be submitted by the trust indenture.

Q. I think you said you also mentioned your reservations respecting the terms under the trust deed to Mr. McFadden. What comment did he offer?

A. Again I can't quote. Perhaps I should say that in taking the attitude I took, I may have been acting out of turn and said, 'I have said my piece', and that was the end of it. However, I do want to make clear that after I took that position, I also informed McFadden and Morgan that in no circumstances would I sign these documents prepared the way they were prepared.

Q. And did you ever sign any since?

A. I never did."

Lytle, whose duty it was to prepare the monthly report, testified[7] that, when he first began to calculate the amount of the senior debt outstanding, he considered from reading the trust deed that the portion of it expressed in American funds should be converted to Canadian dollars at the rate prevailing at the time of calculation, an opinion which was undoubtedly correct. He was then informed that it would be the company's policy to report it as if American and Canadian currency were equivalent in value, but Davidson instructed him to prepare working papers[8] showing the calculation on that basis, then at the "historic" rate of exchange for that prevailing at the time when the debt was incurred, and finally at the current exchange rate which they both agreed was the proper one. The historic rate was the one authorized to be used in the preparation of the quarterly report according to the provisions of the deed of trust. His evidence proceeded as follows:[9]

"Q. Referring to the monthly report for the month of September, 1964, do you recall whether it occurred to you that at the end of that month, if the report had been made out using current rates of exchange in calculating the amount of debt outstanding, the company would have been obviously on the face of the certificate in breach of the requirements of the Trust Indenture?

A. I do recall this, yes.

Q. Was there some discussion with anybody?

A. I believe I drew this to Mr. Morgan's attention in this instance. The suggestion here was that the dollar for dollar basis was still valid and in any event there was always collateral available to cover any shortage.

Q. And what were you instructed to do then so far as the monthly report was concerned?

A. To do nothing.

Q. To do, I suppose, as you had been doing in previous months, and report dollar for dollar, is that correct?

A. Yes.

Q. What did you have to do, if anything, with the annual report? I leave aside the supplementary information for the moment.

A. Certain information was included, particularly with reference to the mix of loans outstanding was assembled and the percentage calculation prepared. Any information relative to collateral analyses was prepared by me.

[7]Evidence Volume 95.

[8]Exhibit 3463.

[9]Evidence Volume 95, pp. 12866-8.

Q. In order to prepare information respecting what you have referred to as the mix of receivables, by which I take it you mean such and such a percentage is commercial lending, such and such a percentage is automobile retail and so on?

A. Correct.

Q. In order to provide that you would have to know what Commodore Sales, Commodore Factors and Adelaide Acceptance were doing or were said to be doing. How did you get that information?

A. This information was provided through Mr. Morgan in a summary form.

Q. Did you have the benefit of any working papers or detail behind the figure handed to you?

A. No.

Q. In preparing the monthly reports and the quarterly reports, how did you learn what Commodore Sales, Commodore Factors and Adelaide figures should be?

A. These again were just presented to me in a summary form on a summary sheet.

Q. And again did you ever have an opportunity to examine the calculations behind the summary form?

A. No, I did not.

Q. Did you ever make any attempt to have access to any of the figures of those subsidiaries?

A. On one occasion I volunteered my services to Mr. Morgan to assist in the Commodore accounting department.

Q. Yes?

A. —and was refused permission.

Q. Why did you on that particular occasion suggest that you could help?

A. On this occasion there was some delay being encountered in monthly financial statements being received in Oakville for the preparation of the consolidated statement, and so I suggested that I might be of some assistance in speeding this up.

Q. Can you recall precisely what it was that Mr. Morgan said?

A. All he said was it would not be necessary."

When the time came to consider the information required for the Robert Morris questionnaire, which was to be first filed for December 31, 1963, Lytle discussed the matter with Morgan, particularly in connection with the yellow form which he correctly thought was applicable to the type of business being done by the Adelaide Street subsidiaries. Morgan disagreed and information concerning the loans of these companies was

never fed into the data processing equipment. Information as to the loans of Commodore Sales Acceptance, Commodore Factors and Adelaide Acceptance was simply provided from Morgan's office in summary form, and even the most casual enquiry which Lytle made to Woolfrey was referred to Morgan who provided the answer without discussion with Lytle and without allowing him access to the collateral records of these companies.

This evidence will become significant when the question of events of default occurring in 1964 falls to be considered. Davidson, as already noted, had become progressively more estranged from Morgan as the operations of Atlantic Acceptance grew more imposing; he was stripped of his offices of general manager and treasurer until he finally occupied only that of secretary, his duties being only of the most formal kind, involving the preparation of corporate records and liaison with the parent company's solicitors. Although he refused to sign the reports submitted to the trustee, disagreement with Morgan was mainly confined to the method of calculating the amount of the senior debt; he did not know, and care was taken to ensure that neither he nor anyone else at the Oakville head offices would find out that receivables of a prohibited type were being pledged as a matter of calculated policy. C. P. Morgan was regarded by all as the final authority on questions involving interpretation of the deed of trust and his opinion was accepted by the Atlantic staff, generally speaking, without question. The head office staff at Oakville did not at any time have access to any detail lying behind the aggregate totals of the receivables of the Adelaide Street subsidiaries and were simply advised of the total amounts outstanding for the purpose of preparing reports to the trustee. I am satisfied that those who signed these reports did not do so knowing that the statements respecting the nature and value of the pledged receivables of these subsidiaries were false and not in conformity with the restrictions laid down in the deeds of trust. The state of their knowledge in this respect illustrates how essential to Morgan's fraudulent scheme was the total separation of the Adelaide Street operations from those conducted at Oakville, safely removed from the eyes of the head office staff and the principal auditors of Atlantic, and under the sole direction of Morgan and his confederates at Walton, Wagman & Co. who produced audited statements upon demand, the effect of which must be referred to in detail in Chapter XVII. Accountants are well aware of the temptation to which finance companies are subject to capitalize delinquent interest rather than to report it as owing and overdue, and they have tests to which the receivables can be subjected which will reveal such a practice if it is being carried on to a significant degree. The lenders to Atlantic no doubt believed that a certificate by the auditors to the effect that during their audit they had not learned of any condition

which could constitute an event of default—for example pledging receivables without deducting the principal arising out of delinquent interest—would be some protection to them. Both Wright, Erickson, Lee & Macdonald, auditors of Atlantic Acceptance up to and including the audit for 1963, and Deloitte, Plender, Haskins & Sells, who performed the engagement for 1964, duly gave such certificates for the fiscal years with which they were concerned. They saw no breach of the covenants as set out in the deeds of trust because the breaches occurred in the pledging of receivables of the Adelaide Street companies, the books of which they did not audit. Walton, Wagman & Co., who did, were spared the necessity of adding one more false certificate to the imposing total which must be charged to them, because they were not required by anyone to certify that no event of default under the trust deeds had come to their attention.

**Limitations on the Issue of Notes under the Deeds of Trust**

The need for Atlantic Acceptance to maintain certain ratios between senior subordinated and junior subordinated debt, with consolidated net worth as a factor common to all, has already been discussed, and the subject must now be pursued in the light of the expedients resorted to by C. P. Morgan to make the company appear to comply with their provisions in this respect. The trust deed for each of these three types of debt established the ratios required by the lenders affected by and relying upon it. It should be noted that the permitted ratio affecting any one class of debt sometimes varied with the trust deed concerned. For example, section 6.10(1) of the trust deed, governing the issue of subordinated notes, required that all notes ranking behind senior debt, including junior subordinated notes, could not exceed 150% of consolidated net worth. On the other hand, section 5.10(1) of the trust deed, relating to the issue of junior subordinated notes, provided that subordinated debt could not exceed 150% of consolidated net worth, plus the amount of junior subordinated notes outstanding; this was a higher ratio than that provided by the subordinated notes indenture. Yet both the trust deeds for subordinated and junior subordinated notes permitted the creation of senior debt in the maximum amount of 400% of consolidated net worth, plus all classes of subordinated debt. None the less this limitation was reduced by the terms of the senior deed of trust which had, by section 6.12(2), always restricted the issue of senior notes to 350% of that calculation, while permitting all notes ranking behind senior notes to rise to 250% of consolidated net worth, and not more, until the execution of the sixth supplemental indenture in September 1962. Since every trust deed must be complied with, Atlantic Acceptance was bound by the most restrictive ratios among

those set out in the different instruments. A simplified illustration of their combined effect must be attempted.

(a) If consolidated net worth increased by $1,000, for example, through the sale of shares for that amount, Atlantic was entitled to create an aggregate of $1,500 of debt represented by either subordinated or junior subordinated notes or a combination of the two; the most restrictive ratio, and therefore the one that governed, was that set out in the subordinated debt trust deed.

(b) Of the $1,500 debt referred to in (a) not more than $1,000 could be junior subordinated debt, since the most restrictive ratio was that found in the junior subordinated trust deed which limited the amount of notes which could be issued under its provisions to a sum equal to consolidated net worth.

(c) If Atlantic created $1,500 additional debt in the aggregate of either the subordinated or junior subordinated class it would have received new funds in the amount of $2,500 ranking behind the senior debt, $1,000 being the necessary addition to consolidated net worth and $1,500 consisting of the additional debt; it would then be entitled to create new senior debt up to 350% of $2,500 or $8,750.

(d) Thus for every increase in consolidated net worth of $1,000 Atlantic was entitled to borrow, against the issue of notes subject to the limitations by class set out above, a total of $11,250 more than it had been entitled to borrow before.

It will be observed that the breach of these ratios could not be readily concealed by false reporting to the trustee and the noteholders, or buried in the Adelaide Street companies. The amount of the debt by class was known to the trustee from its own records and would become known to the head auditors of the company in the course of their audit, and to the lenders when the annual audited financial statements were issued. Compliance was therefore essential, and to create merely the appearance of compliance without complying actually and in good faith required much more sophisticated techniques than those employed to defeat other restrictions in the deeds of trust to which reference has already been made. But, unfortunately for noteholders and shareholders alike, C. P. Morgan was able to meet this challenge and the technique which he used will be the more easily understood if it is first generally described and then instances given of its employment. As already remarked, senior notes were the easiest to sell to lenders and senior debt was the cheapest for the company to service. To raise the limit up to which senior debt could be created it was first necessary either to increase consolidated net worth by adding to it from profitable operation

or by selling shares, or to increase debt ranking behind the senior debt by selling subordinated or junior subordinated notes. The devices used by Morgan, from the very beginning of Atlantic's history, to inflate reported profits and thereby increase consolidated net worth have already been mentioned in Chapter II and will be returned to in greater detail in Chapter XVII. It was not, however, always possible to find purchasers for shares or subordinated and junior subordinated notes sufficient to permit the limit on senior debt to be raised to a level where enough money could be borrowed to satisfy Atlantic's voracious appetite. Its president was, nevertheless, quick to see that the creation of more senior debt depended upon the company at least appearing to receive additional money ranking behind it. Atlantic had money at its disposal—money and promises to repay money were indeed its inventory—and if this could be used to cause shares or subordinated notes to be bought the problem was solved. To be sure, the purchase of its own shares by a company with its own money in these circumstances was a breach of section 23(1) of the Corporations Act of Ontario, and any of Atlantic's notes purchased with its own money could not be considered by lenders to it and their trustee as being in any way part of the company's debt, let alone debt subordinated to the senior notes. Accordingly an accomplice or confederate would be required to conceal the nature of any transaction which involved the use of the company's own funds to produce debt or issued shares, appearing to introduce into its coffers money which had not been there before.

Such confederates materialized in the latter part of 1964 in the persons of Jack Tramiel and George H. Weinrott, and Morgan's technique was in full flower when over $2,000,000 of Atlantic money left its bank account, travelled full circle through Hugo Oppenheim und Sohn in Berlin and returned to Atlantic to pay for the purchase of common shares out of its treasury. That transaction, described in detail in Chapter X, had the effect of compelling Great Northern Capital Corporation to purchase an additional 120,000 common shares, so that the consolidated net worth was increased by $4,000,000 in U.S. funds and the company thereby became entitled to create an additional $41,000,000 of debt. The first transactions of this nature, however, were more tentative and exploratory than this great stroke, and much more modest in scale. They began a full two years before in the autumn of 1962.

### Manipulation of the Borrowing Base

It is useful to recall that the original trust deed securing senior notes permitted subordinated debt to be issued up to, but not exceeding 250% of consolidated net worth, and that the more restrictive limitation of 150% did not come into effect until the sixth supplemental indenture

was executed as of September 24, 1962. Atlantic Acceptance at December 31, 1961 had, as may be seen by reference to Table 1, subordinated debt of $6,933,059 and consolidated net worth, after making adjustments for certain intangible assets required by these instruments, of $2,865,133; hence its level had almost reached the permitted maximum and constituted some 242% of consolidated net worth. However, more freedom of action was available to the company in the category of senior debt which, at December 31, 1961, amounted in the aggregate to $21,275,791, or roughly 222% of subordinated debt, plus consolidated net worth as defined, compared with a maximum permitted of 350%. Then, in May and June of 1962, additional senior long-term debt was created amounting to $6,018,984; thereafter, until September 30, senior short-term notes were issued for $9,737,008. Thus, at the end of the third quarter of 1962, the senior debt had reached a total of $37,031,783, or something in the order of 386% of the "borrowing base" subordinate to it as calculated at the beginning of the year. Since, on September 25, arrangements had been made for the issue of still more senior notes in the amount of $5,000,000 on October 4, it was imperative that the borrowing base be shown at a higher figure on the September 30 quarterly report[1] to bring this excessive senior debt within the prescribed limitation. With subordinated debt already near its permitted peak and senior debt well beyond it, there was desperate urgency to relieve the situation by enlarging consolidated net worth which could only be done by the sale of shares.

Accordingly, Atlantic arranged to sell 45,000 second preference shares Series "A" to the Ford Foundation and covenanted in an agreement with that institution, dated September 28, 1962, that a total of 95,000 of these shares would be sold by October 4 which was the date of closing the sale of senior notes for $5,000,000.[2] By the sale of these shares at a price of $24 per share the company realized $1,080,000. An additional 5,000 shares at the same price was bought by the Montreal Trust Company, but consolidated net worth was only increased through these transactions by $1,200,000, and an additional $1,080,000 had to be sold to regularize the issue of $5,000,000 of senior debt for which the date of closing was rapidly approaching. Therefore a purchaser was needed at once for the remaining 45,000 second preference shares and that purchaser must be "an exempt institution" under the Securities Act, a chartered bank, an insurance company or a trust company, or an institution such as the Ford Foundation in respect of which a waiver could readily be obtained from the Ontario Securities Commission; otherwise a prospectus must be filed with that body as a prerequisite of sale of the shares to the public, and for this there was no time.

[1]Exhibit 86.
[2]Exhibit 25

## British Mortgage & Trust Company Comes to the Rescue

What follows is part of the history of British Mortgage & Trust Company and has been referred to generally in that portion of Chapter XV dealing with that company's massive investments in the securities of Atlantic Acceptance.[1] By agreement dated September 28, 1962[2] it subscribed for 75,000 of Atlantic's second preference shares Series "A" at a price of $24 per share and agreed to pay for and take delivery of 45,000 shares on October 4 and an additional 30,000 on November 15. This agreement, which required an outlay of funds by British Mortgage of $1,800,000 by November 15, was signed for the trust company by Wilfrid P. Gregory. The minutes of the meeting of its executive committee for September 25, 1962[3] record, however, only the authorization of a purchase of 20,000 of these shares and of a loan to "Powell Morgan" of $480,000 to facilitate his purchase of 25,000 shares; according to this record, no mention was then made in the deliberations of the executive committee of the additional 30,000 shares which Gregory had committed the trust company to buy. At the Atlantic end of this transaction the $1,080,000 attributable to the purchase of 45,000 shares on October 4 was shown in the quarterly report to the trustee, as at September 30,[4] as a subscription received for part of an issue of 125,000 second preference shares included in the vital equity section of the financial statement of that date; this amount was elsewhere shown on Atlantic books as an investment of British Mortgage & Trust Company,[5] although it had not materialized at that date. As further evidence of the spirit in which this report was made, note 6 to that financial statement, dealing with the issue of 125,000 second preference shares, refers to Atlantic obtaining supplementary letters patent, authorizing the required increase in the company's capital stock, as having occurred "during 1962", thus effectively lulling any suspicions on the part of trustee, noteholders and shareholders alike which might have been aroused by the haste in which they had in fact been obtained on September 25, the very day that the British Mortgage & Trust executive committee had been asked to authorize the purchase of part of them.

The restrictions on investment to which British Mortgage & Trust, in common with other trust companies, was subject by the operation of the Loan and Trust Corporations Act have also been dealt with in Chapter XV.[6] By September 30, 1962, British Mortgage & Trust had invested in the securities of Atlantic Acceptance, including the investment to which it had been committed by the agreement of September 28, a sum exceeding $10,000,000 which was three times the authorized limit for

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[1] pp. 1024-44.
[2] Exhibit 25.
[3] Exhibit 112, p. 3990.
[4] Exhibit 86.
[5] Exhibit 4291.
[6] pp. 1011-1029.

such investment at that date. However, by the end of October, when it reported on its affairs to the Registrar of Loan and Trust Corporations, its investment in Atlantic securities appears as a total of $3,260,777 of which only $282,000 is attributable to 11,780 of the finance company's second preference shares, represented as being all that the trust company held at that date.[7] The corporate records of British Mortgage & Trust must again be resorted to. The minutes of the meeting of the executive committee for October 9 state that it had received a total of 45,000 of the Atlantic second preference shares, and a resolution was passed authorizing execution of the necessary transfers for the purpose of refinancing 33,250 shares and retaining 11,750, although no recorded comment is made, or explanation offered of the fact that 45,000 shares had been delivered when the committee had, as recently as September 25, authorized the purchase of only 20,000. Indeed, on October 4, a regular meeting of the board of directors of British Mortgage & Trust had approved the decision of the executive committee taken on September 25, and the agenda attached to the minutes also refer to the purchase of 20,000 shares and a loan of $480,000 to Morgan against the purchase of 25,000. No mention is made of the 45,000 shares as such, or of the additional purchase of 30,000 on November 15 undertaken by Gregory. The executive committee's minutes of November 27[8] refer to the receipt of 20,000 Atlantic second preference shares and a decision to retain only 11,250, and to distribute the balance among certain estates, trust, and agency accounts, as previously authorized, and to Annett and Co. in Toronto. By November 27 a total of 3,170 shares had been sold to these accounts, and almost all the purchases were financed by the redemption of British Mortgage & Trust Company deposit receipts or the sale of other securities.

At November 30, 1962, by which date British Mortgage had bound itself to purchase an additional 30,000 second preference shares, it held for its own account only 21,450 instead of the 75,000 for which it had contracted to pay, but Atlantic Acceptance had received payment from someone of $1,800,000 for selling them. The explanation is this: British Mortgage did not take delivery of or pay for the 45,000 shares it was to buy on October 4. C. P. Morgan bought 25,000 of these shares and borrowed the money to pay for them from the trust company, this being the first of its collateral loans to Morgan and companies with which he was associated. British Mortgage & Trust sold 8,220 shares immediately to a number of purchasers in the Stratford area, and during November a further 5,330 shares, to reduce its holdings to the 21,450 which it had at the end of that month. When November 15 came, and the trust company was to take delivery of a further 30,000 shares, Atlantic issued 15,000 to Annett & Co. who lodged them with Harry

[7]Exhibit 2561.5.
[8]Exhibit 112, p. 4030.

Wagman in trust for Aurora Leasing Corporation which lent the entire purchase price of $360,000 to Annett & Co. for the purpose, having borrowed it from Commodore Sales Acceptance.[9] Thereafter, and over a period of some six months, Annett & Co. sold their shares to the public and repaid Aurora Leasing the principal amount of the loan and interest at 8½%. Public distribution had apparently been contemplated from the beginning. The share register of Atlantic Acceptance (not an exhibit in evidence but in the custody of the Commission) shows that on October 4 the first three certificates were issued to the Ford Foundation, British Mortgage & Trust Company and the Montreal Trust Company for 45,000, 45,000 and 5,000 shares respectively. British Mortgage & Trust's certificate No. 2 was transferred into certificates 23 to 38 of which certificate 23 was for C. P. Morgan's 25,000 shares, certificate 27 for Annett & Co.'s 3,500, the remainder being registered in the names of various British Mortgage accounts and individuals to which the shares were sold, including three residents of the United States, and certificate 38 for the trust company's 11,750 shares. On November 15 British Mortgage & Trust was issued certificates 45, 46 and 47, each for 10,000 shares, of which 3,000 were forthwith transferred to Annett & Co. and 2,000 to Welland Securities Limited; on December 6 a further 10,000 shares were transferred to the Annett firm. Of the 16,500 shares thus acquired by Annett & Co. 15,000 were pledged with Aurora Leasing for the loan granted by that company of $360,000 of Atlantic funds, were released bit by bit as this loan was paid off and sold in turn to such clients as Roytor & Co., A. S. Leman, Corporate Investors and M. D. Morse. Although the distribution by the two trust companies was permissible since they were exempt institutions, it would appear that the sales by Annett & Co., which took place between December 12, 1962 and March 7, 1963, constituted primary distribution to the public, without benefit of a prospectus or leave by the Ontario Securities Commission which may wish to investigate the matter in due course.

**Summary of the Transaction**

This whole transaction, involving the last-minute distribution of 95,000 Atlantic second preference shares, so typical of C. P. Morgan's ingenuity and W. P. Gregory's complaisance, achieved the end of raising the ceiling on senior debt by the increase of consolidated net worth in a manner which was improper on the following counts:

(a) It introduced British Mortgage & Trust Company as the alleged purchaser of 75,000 shares when in fact it only professed to purchase 40,000, thus avoiding the need to file a prospectus and permitting distribution of the shares among members of the public.

[9]Exhibit 967.

(b) It involved the employment of $360,000 of Atlantic funds for the purchase of the company's own shares to give the appearance of an addition to consolidated net worth, and thereby enabled senior debt to be increased allegedly within the ratio permitted by the deed of trust.

(c) It resulted in British Mortgage & Trust Company binding itself to purchase 45,000 of these shares on October 4, 1962, at which time it was already in very substantial breach of the statutory limitation on investment in Atlantic securities, and ridding itself of 25,000 of them before the date on which it was required to report such investments to the Registrar by lending 80% of the purchase price to C. P. Morgan. This having been done once, it soon became commonplace after this date and, as described in Chapter XV, whenever it appeared desirable to finance the purchase of treasury shares of Commodore Business Machines or other companies in the Atlantic complex, funds of British Mortgage & Trust which had been so helpful on this occasion were frequently resorted to.

(d) It involved a falsification of Atlantic's quarterly report to the trustee for September 30, 1962.

It is unnecessary to dwell at any length upon other instances of the device here employed, since they have been dealt with in some detail elsewhere in this report. Suffice it to say that in this case Atlantic funds had been employed to finance the purchase of its shares only to the extent of $360,000. In June 1964 Atlantic advanced $2,000,000 of its funds to enable Cimcony of Canada Limited to purchase "junior subordinated" notes for that amount and increase the borrowing base at a critical period, as described in Chapter IX.[1] The elaborate and ingenious scheme which drew Hugo Oppenheim und Sohn into the Atlantic orbit specifically for this purpose is the theme of virtually the whole of Chapter X and involved another outlay of Atlantic money to the extent of $2,500,000 in U.S. funds. It may be said with some confidence that a total of roughly $5,000,000 of the company's own funds were from time to time employed in the purchase of its own securities to prevent an open and irretrievable breach of the limitation on borrowing contained in the deeds of trust by means of conscious and deliberate deception practised upon those who held them.

## Juggling the Conversion Rate in 1964

Notwithstanding the employment of measures thus far described to create a false appearance of compliance with the limitations and ratios set out in the deeds of trust, particularly the 350% ratio required

[1] pp. 606-7.

in section 6.12(2) of the trust deed securing senior notes, so insatiable was the appetite of Atlantic Acceptance for money that by the autumn of 1964 the company was again in the position that an honest report to the trustee would have revealed a breach of that ratio. A new device was required to conceal the true state of affairs, and C. P. Morgan from his post of vantage at 100 Adelaide Street West was equal to the occasion. In the course of his examination of the company's affairs in August, September and December of 1964 to test the accuracy of monthly reports at the end of those three months, a quarterly report on September 30 and an annual report at December 31, Mr. James made a detailed study of the incidence of the 350% ratio for those periods, with a view to determining what breach, if any, of the covenant contained in section 6.12(2) might have occurred. The results of the examination appear at pages 1327-30 in the section of this chapter entitled "Summary of Accounting Evidence of Events of Default in 1964" to which reference should be made. At the end of August the consolidated net worth of the company and its subsidiaries, after the prescribed adjustment requiring the deduction of fixed and intangible assets, was $9,935,993.[1] The subordinated debt, excluding notes held by Cimcony of Canada, when added to the adjusted consolidated net worth produced the sum of $23,249,132. Atlantic was accordingly prohibited from having senior debt in excess of $81,371,962 which was 350% of that figure, but in fact the senior debt outstanding exceeded the limit by $2,565,254. The company had been able to conceal what would otherwise have been an event of default, plainly visible, by lending $2,000,000 to Cimcony of Canada for the purchase of junior subordinated notes which, although partly repaid by the end of August, still provided an apparent increase in the junior subordinated debt of $1,080,000, and effectively authorized an additional $3,780,000 of senior debt. By the end of September, however, at which time the longer and more detailed quarterly report to the trustee was required, even the Cimcony of Canada loan was insufficient to conceal the facts of the situation, and Atlantic, had it reported accurately, would have been seen to have created $9,056,130 of senior debt in excess of that allowed by the 350% limitation. Two steps were taken to enable the filing of a quarterly report which concealed what would otherwise have appeared as a glaring event of default.

The first was that already described in Chapter X,[2] whereby Atlantic obtained a loan of $2,000,000 from Great Northern Capital Corporation, its principal shareholder, and issued a senior note for that amount which was outstanding on September 30. Atlantic had received a letter from Great Northern Capital expressing its intention to invest $2,000,000 in the company's common shares thereafter if several conditions were

[1]Exhibit 3468.
[2]pp. 686-8.

met; many of these had not been met at September 30 and Atlantic did not have a subscription from Great Northern Capital for the 120,000 shares which the latter intended to buy, but it did have outstanding a note which was clearly senior debt. In the quarterly report for the period ending September 30[3] which contained a certificate from P. D. McCaughey, as principal accounting officer, that there was no breach of any covenant under the deeds of trust, including that relating to the 350% ratio, this note was simply not included in the senior debt outstanding. The second step taken was to add $2,000,000 to the consolidated net worth as if the Great Northern Capital subscription had been received, and the effect of this was to appear to justify issuing an additional $7,000,000 in principal amount of senior debt, while understating it by $2,000,000.

September 30 was a date for which both monthly and quarterly reports were required to be filed. The Third Schedule monthly report did not require a disclosure of information from which it could be learned whether the 350% ratio was being observed or not; the company could safely include, in the calculation of senior debt for this report, Great Northern Capital's $2,000,000 senior note and this it did. The monthly and quarterly reports were thus directly at variance in their treatment of this large sum of money, since one applied it to senior debt and the other to consolidated net worth. The device was cruder than most of those employed by Morgan and involved more risk, but the fact that no one noticed the discrepancy between the two reports can be attributed to the bewildering complexity of rules, laid down in the senior trust deed, for calculating the rate of exchange required to convert American dollars into Canadian dollars for purposes of the monthly and quarterly reports, as a result of which the amount of senior debt reported in the monthly report was not expected to be the same as that in the quarterly report.

Since Atlantic Acceptance borrowed both United States and Canadian funds it was necessary to provide in the deeds of trust rules for calculating the rate of exchange to be applied when its debt was stated in Canadian dollars. The trust deed securing senior notes had two such provisions; the first was provided by section 2.02 which read in part as follows:

> "In the case of the Series A Notes and if the Company shall at any time have outstanding any additional Notes of subsequent series the principal of, and premium (if any) and interest on, which is payable only in a currency or currencies other than lawful money of Canada, the principal amount of, and all other amounts payable in respect of, all such notes shall, at any particular time, for the purposes of all calculations or determinations under this indenture unless otherwise specifically stated herein, be deemed to be the equivalent Canadian dollar

[3]Exhibit 86.

> amounts thereof, calculated at the rate of exchange in effect at the time of the original issuance of such Notes, as determined by the Directors in a manner satisfactory to the Trustee."

In other words, the general rule was that the company should use what are called "historic" rates of exchange or the rate prevailing at the date of the issue of the obligations. An exception was, however, allowed in section 6.12(1)(D), dealing with the maintenance of the security and, specifically, with the pledging of finance receivables amounting to 115% of the principal amount of senior debt, which provided, "for the purpose of computations under this §6.12(1), Notes payable in United States dollars shall be converted into Canadian currency at the current rate of exchange". In the monthly reports, therefore, the current rate of exchange was to be applied and, although in 1961 some long-term notes had been sold when the rate of exchange favoured the Canadian dollar, by far the greater number of notes outstanding in the autumn of 1964 had been sold when the United States dollar was at a premium in terms of the Canadian. Therefore, at this point, both calculations, whether according to the historic rate or the current rate of exchange, resulted in the number of Canadian dollars owing on notes being greater than if the two currencies were deemed to be at par, the current rate yielding a higher figure than the historic rate in the calculation of senior debt. As at September 30 the company was required to calculate this debt for the monthly report, as an illustration of its observance of the covenant to pledge finance receivables amounting to not less than 115% of the principle amount, by converting United States dollars into Canadian at the current rate of exchange. This requirement was well understood, as appears by the fact that the current rate had been used in the monthly report for August 31. If it had applied the same and proper rate for the calculation at September 30, the senior debt outstanding would have been shown as amounting to $89,773,380, plus accrued interest of $648,915, and this would have required the pledging of finance receivables amounting to $103,985,639.[4] Even on the assumption that all its receivables actually pledged with the trustee were admissible under the deed of trust, the total came to $101,726,825.[5] The way around this obstacle chosen by the company was barefaced and simple; in the September report it promoted the Canadian dollar to par in terms of the American and made no adjustment for the difference in exchange, although at the time the rate was approximately 7¾% in favour of the United States dollar. The outstanding American debt at the time was in the order of $40,000,000 and the difference, amounting to just under $3,000,000, concealed by this stroke was substantial.

[4]Exhibit 3461.
[5]Exhibit 3458.

Although the company had treated the Great Northern Capital note as it was required to do for the monthly report, it compensated for this honesty by ignoring the rate of exchange.

This cannot be considered inadvertence; indeed evidence that a decision to ignore the rate of exchange was deliberate, and made by C. P. Morgan, is convincing. Lytle, as will be recalled, himself drew Morgan's attention to the situation, since he had prepared, as instructed by Davidson, calculations reflecting the amount of senior debt outstanding at all three of the historic, current and equivalent rates. According to his evidence, he had, without authorization, been using the current rate as required by the trust deed, and its use for the August monthly report may well be attributed to him. In any event, his working paper for the September 30 calculation[6] shows that Atlantic would have been effectively in default on the application of either the historic or current rates, and only by treating the two currencies as exactly equivalent could an acceptable report be made. For the quarterly report the company was required to convert its United States dollar debt into Canadian dollars at the historic rate as provided by section 2.02. Since it had in this report included Great Northern Capital's $2,000,000 in equity and excluded it from senior debt, and had thereby achieved a difference of $7,000,000 in the permitted level of senior debt and apparently reduced the outstanding figure by $2,000,000, it was evidently not considered necessary to treat United States and Canadian dollars as equivalent for this calculation and an effort was made to apply the proper historic rate of exchange. It may be noted again that no one reading the monthly and quarterly reports together would have been surprised to see two different amounts shown for senior debt outstanding as at the same date, since they would inevitably have been different if calculated one at the current rate and the other at the historic rate. As Mr. James' calculations show,[7] if the $2,000,000 contributed by Great Northern Capital had been properly included in the senior debt as evidenced by short-term note No. 2416, still outstanding at September 30 and not classified as capital stock, and if Cimcony of Canada's outstanding indebtedness of $1,080,000 had been deducted from subordinated debt as it should have been because it was not properly a debt at all, the 350% limitation on the senior debt, as imposed by section 6.12(2) of the senior trust deed, would have been exceeded at September 30 by $9,056,130. Lytle, of course, cannot be entirely absolved from complicity in this matter. No doubt he should have advised the trustee on his own and taken the consequences. Nevertheless, one is tempted to look with a compassionate eye upon the shortcomings of subordinates, however aware of the improprieties being urged upon them by the presi-

[6]Exhibit 3464.
[7]Exhibit 3468.

dent of the company which employed them. The provisions of the trust deeds constituted a code of law, as it were, by which the company was to abide, but there was no provision for a police force to detect breaches of that law. The lenders relied on the good conscience and probity of the company's officers and these proved to be guardians unequal to the task.

**Duties of the Trustee**

There remains the trustee which, in the case of all the deeds of trust securing all levels of debt and all those deeds supplemental to them, was the Montreal Trust Company. Although the covenants in each one of them were made between it and Atlantic Acceptance Corporation as borrower and issuer of the notes representing its debt, the nature and extent of the powers of the trustee were effectively derived from the lenders. It would be an over-simplification to say, as has been said in the course of recent investigations which will be examined at the conclusion of this chapter, that individual noteholders were at the mercy of agreements to which they had not subscribed. They relied, indeed, upon the trustee which, within appreciably narrow limits, was bound to act on their behalf; yet in fact they were more apt, even if not entitled, to rely on the *savoir faire* of the impressive institutions and corporations and the expertise of the lawyers who had created limitations under which Atlantic Acceptance bound itself to operate as long as it was indebted to them. These important lenders in their turn played a game of "follow-the-leader"; their officers who authorized the purchase of Atlantic notes were rarely concerned with the terms of the deeds of trust under which they were issued, but were undoubtedly influenced by the prestige of lenders who had preceded them in the purchase of Atlantic securities and by that of its fiscal agent in the United States, Kuhn, Loeb & Co. It is not to be expected that even the most experienced businessmen had either the inclination or the time to look behind such real, though intangible assurances as are provided by fiscal agents and lawyers of international and unblemished reputation. Nevertheless, it is necessary to look briefly at the duties of the trustee, as prescribed in the deeds of trust which are set out in detail in the composite indenture at Appendix K.

Briefly stated, the trustee's duties were:

(1) to stand possessed of the pledged receivables, to keep an accurate register of them, and to handle, stamp, endorse and otherwise deal with every receivable pledged;

(2) to execute supplemental indentures;

(3) to designate a depositary;

(4) to perform certain routine tasks in receiving evidence of the company's compliance with covenants to maintain security of the noteholders, described in paragraphs (B), (C), and (D) of section 6.12(1); and

(5) to receive the monthly, quarterly and annual reports and, in respect of the monthly report, the trustee was only to ensure that the company did not report as being pledged receivables of an amount higher than the face value of the notes lodged with the depositary. As to the contents of all reports section 6.12(1)(C) provided as follows:

> "The Trustee shall be entitled to rely upon such certificates and instruments in writing and shall be entitled to treat the same as conclusive proof of the fact stated therein, and shall not be responsible for any errors occurring therein, and shall be under no duty to verify the correctness of the same except to verify that the aggregate face amount of Finance Receivables lodged with the Trustee as of the date shown thereon is not less than the aggregate amount of indebtedness owing upon Finance Receivables shown in paragraph (1) of such certificate of the Company."

(6) Under Article X, entitled "Remedies in Case of Default", the trustee had numerous duties and was allowed wide discretion, detailed examination of which is not within the terms of reference of this Commission, although some comments have been offered by the way and inevitably in the course of this report.

(7) Under Article XVIII, entitled "Administration of the Trust and Protection of the Trustee", consisting of section 18.01, are a number of saving clauses relieving the trustee of liability for reliance upon the advice of experts and certificates of the officers of the company, and it is expressly stated that it shall only be "accountable for reasonable diligence in the management of the trusts hereof" and "only be liable for its own wilful acts and defaults". In the exercise of its powers it shall have "absolute and uncontrolled discretion . . . whether in relation to the manner or as to the mode of and time for the exercise thereof, and in the absence of fraud, it shall in no wise be responsible for any loss, costs, damages or inconveniences that may result from the exercise or non-exercise thereof". Finally the trustee is not bound to see to the performance by the company of any of its obligations under the trust deed until the security becomes enforceable or, in other words, until an event of default occurs, and it shall have either decided to enforce it or been required to do so in writing by the holders of 25% of the principal amount of notes issued, or by resolution of the noteholders, and then only if it has been indemnified by them against all actions and against damages and the costs of proceedings arising out of them.

There is no evidence before the Commission after prolonged examination of the actions of the trustee, in the course of which the Commission was afforded every assistance by the Montreal Trust Company, that it had in any way failed faithfully to discharge its duties and perform its obligations as set forth under the deeds of trust.

### Summary of Accounting Evidence of Events of Default in 1964

*(i) Limitations of Section 6.12(1) of the Senior Trust Deed*

From what has already been said it is clear, from the time that Atlantic Acceptance Corporation entered the money market in the spring of 1961, C. P. Morgan had made up his mind that, when limitations on borrowing imposed by the deeds of trust stood in the company's way, these instruments would, in the words which he used to David Davidson, be "thrown out of the window". These bold words were translated into deliberate and ingeniously fraudulent action, as circumstances required, designed to deceive the trustee and the holders of Atlantic securities. The calculations developed by Mr. James were, of course, the result of an investigation, informed by knowledge acquired after the finance company's collapse, using materials which were not only unavailable to the trustee but concealed from the accounting officers of the company at its head offices in Oakville who were dealing daily with large amounts of its legitimate business. Nevertheless, it should again be emphasized, as it was at the beginning of this chapter, that in considering the nature of the notes and accounts receivable pledged with the trustee by Atlantic's subsidiary companies, Commodore Sales Acceptance, Commodore Factors, Adelaide Acceptance and Premier Finance Corporation, Mr. James proceeded on the assumption that these were worth what they were said to be worth by these companies and that proper allowances for bad debts had been made. When he testified the evidence on that subject had not yet been given and it is fully discussed in the next chapter. The periods for which tests were applied by Mr. James were in most cases the months of August, September and December 1964, because these provided contemporaneous examples of monthly, quarterly and annual reports, and the figures, being comparatively recent in the company's history, were the more easily checked.

Dealing first with the requirements of section 6.12(1) of the deed of trust securing senior notes, there were three limitations in terms of which accounting tests were made. The first was the provision that the sum of finance receivables, as defined, should at all times be not less than 115% of the aggregate principal amount of all senior debt outstanding. The amounts of receivables pledged, as reported for the three months in 1964 on the monthly report prescribed by the Third Schedule, together

with Mr. James' adjustments, which are self-explanatory, are given below.[1]

ATLANTIC ACCEPTANCE CORPORATION
Trust Indenture
FINANCE RECEIVABLES PLEDGED IN TERMS OF SECTION 6.12 (1)

| | 1964 | | |
|---|---|---|---|
| | *August 31* | *September 30* | *December 31* |
| Atlantic Acceptance Corporation | $ 40,030,411 | $ 41,060,135 | $ 44,700,776 |
| Atlantic Finance Corporation | 23,439,056 | 24,674,462 | 28,824,063 |
| Commodore Sales Acceptance | 24,483,037 | 25,184,485 | 25,180,979 |
| Commodore Factors Limited | 5,788,769 | 5,584,050 | 5,039,033 |
| Adelaide Acceptance | 5,776,152 | 5,705,106 | 4,500,211 |
| Premier Finance Corporation (estimated) | 2,200,000 | 2,100,000 | 2,000,000 |
| As shown on the 3rd Schedule | 101,717,425 | 104,308,238 | 110,245,062 |
| Less | | | |
| Repledge Deficiency | | | |
| Atlantic Finance | 1,669,221 | 1,684,612 | 2,249,830 |
| Adelaide | 948,569 | 896,801 | 66,615 |
| As shown on the 3rd Schedule | 2,617,790 | 2,581,413 | 2,316,445 |
| Net Total | $ 99,099,635 | $101,726,825 | $107,928,617 |
| Adjustments | | | |
| 1) Incorrect figures used for Atlantic Acceptance capital loans deposited. Face value used instead of balance owing | — | — | (95,361) |
| 2) Correction to make Premier estimates above equal actual | 29,322 | 38,798 | (143,770) |
| 3) Incorrect figures used for inter company balances thus affecting repledge deficiency | 32,000 | 32,000 | — |
| 4) Adelaide figures above include provision for doubtful accounts—excluded in December so deduct for August and September | (64,025) | (71,115) | — |
| 5) Adelaide's August figures do not include the interest receivable | 16,988 | — | — |
| Adjusted Pledged Receivables | $ 99,113,920 | $101,726,508 | $107,689,486 |
| Face value as per depositary's monthly certificate | $123,496,591.23 | $156,520,761.00 | $134,796,178.38 |

Two observations should be made: the receivables for Standard Discount Corporation, together with that portion of those of Premier Finance which had been assumed by the former for collection, were not pledged because of the high rate of turn-over in the type of finance business which they represented, and it was not considered practicable to do the necessary clerical work; second, the very large figure for the face value of receivables lodged at September 30, as reported by the depositary, was the result of what must be considered an error in its certificate, overstating their face value by some $30,000,000.

The second limitation of section 6.12(1) with which these tests were principally concerned was contained in the fourth supplemental

[1]Exhibit 3460.

indenture and was applicable at this period. The exact wording should be considered:

> "The aggregate principal amount of Pledged Finance Receivables having in each case an original principal amount of more than U.S. or Canadian $15,000 shall not at any time exceed (i) 20% of the aggregate principal amount of all Pledged Finance Receivables at such time or (ii) 250% of Consolidated Net Worth at such time, whichever is smaller."

The figures for 20% of the pledged receivables were always smaller than the calculation of consolidated net worth, so that the following table[2] shows the effect of this limitation and the extent to which it was observed, particularly in terms of the device of splitting up large receivables into promissory notes of exactly $15,000.

ATLANTIC ACCEPTANCE CORPORATION

Trust Indentures

Section 6.12(1)

(Not more than 20% of Receivables may be pledged in amounts of more than $15,000)

| | 1964 | | |
|---|---|---|---|
| | *August 31* | *September 30* | *December 31* |
| Gross receivables lodged as per Third Schedule | $101,717,425 | $104,308,238 | $110,245,062 |
| Net figures corrected as per calculations | 99,081,920 | 101,694,508 | 107,689,486 |
| Add back corrected Repledge Deficiency | 2,585,790 | 2,549,413 | 2,316,445 |
| Adjusted Aggregate Receivables | 101,667,710 | 104,243,921 | 110,005,931 |
| Limitation imposed by Section 6.12(1) 20% of aggregate receivables | $ 20,333,542 | $ 20,848,784 | $ 22,001,186 |
| Amounts exceeding $15,000.00 | | | |
| Figures below extracted from analysis schedules at the dates above. | | | |
| Atlantic Acceptance Corporation (September and December estimated) | $ 7,049,031 | $ 7,000,000 | $ 7,000,000 |
| Commodore Sales Acceptance | 5,525,616 | 5,704,975 | 5,666,162 |
| Commodore Factors Limited | 911,848 | 959,289 | 554,401 |
| Adelaide Acceptance Limited | 2,823,068 | 2,805,943 | 2,051,364 |
| Atlantic Finance Corporation | — | — | — |
| Premier Finance Corporation Limited | — | — | — |
| | 16,309,563 | 16,470,207 | 15,271,927 |
| Amounts exactly $15,000 | | | |
| Notes were frequently split into notes each of $15,000 to evade the restrictions under the Section | | | |
| Adelaide Acceptance Limited (i) | 1,150,000 | 1,100,000 | 1,100,000 |
| Commodore Sales Acceptance (ii) | 8,149,000 | 8,149,000 | 8,149,000 |
| Commodore Factors Limited (iii) | 502,000 | 502,000 | 502,000 |
| | 9,801,000 | 9,751,000 | 9,751,000 |
| Amounts of $15,000 or greater | $ 26,110,563 | $ 26,221,207 | $ 25,022,927 |
| Exceeds limitation by | $ 5,777,021 | $ 5,372,423 | $ 3,021,741 |
| Say | $ 5,777,000 | $ 5,372,000 | $ 3,021,000 |

(i) Frederick's, Phantom Industries, Valley Farm
(ii) Aurora, Pro Musica, Daylite of Grand Bahama
(iii) Commodore Business Machines, Nevil Enterprises, Symphony Paint

[2]Exhibit 3462.

If it is conceded that C. P. Morgan was, strictly speaking, entitled to adopt the device of substituting for "receivables" the words "promissory notes", in pledging numbers of them each with a value of $15,000, it is nevertheless instructive to see what effect this device had on the observance of a covenant which the shareholders believed to be effective.

The third limitation under section 6.2(1) has already been illustrated by tables[3] demonstrating the extent to which the receivables of any one obligor exceeding $500,000 were pledged with the trustee, contrary to the provisions of another limitation contained in the fourth supplemental indenture. The exact wording of this limitation, already quoted, may yet be conveniently repeated here:

> "Finance Receivables included in any computation pursuant to this subsection A or included in the amount stated in paragraph (1) of any certificate of the Company delivered pursuant to subsection B of this Section 6.12(1) (hereinafter in this subsection A called 'Pledged Finance Receivables') shall not at any time, include Receivables in respect of any single obligor (other than a Subsidiary) in an aggregate principal amount exceeding (i) U.S. or Canadian $500,000 or (ii) 20% of Consolidated Net Worth at such time, whichever is smaller; provided that Finance Receivables upon which an obligor is only contingently liable shall not be deemed to be Finance Receivables in respect of such obligor for purposes of this sentence."

The figures set out below[4] incorporate both the calculations set out above as to pledged receivables and those relating to receivables of an obligor in excess of $500,000, being only contingently liable and not a subsidiary. From the latter have been excluded the receivables factored with the Adelaide Street subsidiaries.

SUMMARY SCHEDULE OF POSITION OF
LIMITATIONS UNDER SECTION 6.12 (1)

Pledged finance receivables shall not at any time be less than 115% of the total senior debt outstanding.

| | 1964 | | |
|---|---|---|---|
| | *August* | *September* | *December* |
| *Atlantic Acceptance Calculations* | | | |
| Senior debt outstanding at 115%....... | $96,934,196 | $ 99,542,569 | $106,199,295 |
| Pledged finance receivables............ | 99,099,635 | 101,726,825 | 107,928,617 |
| Within limitations of 6.12 (1) by:. | 2,165,439 | 2,184,256 | 1,729,322 |

[3]pp. 1299.
[4]Exhibit 3458.

| | | | |
|---|---|---|---|
| *Adjusted figures* | | | |
| Principal amount of senior debt at 115%. | $96,830,062 | $103,239,387 | $106,551,483 |
| Pledged finance receivables............ | 99,113,920 | 101,726,508 | 107,689,486 |
| Within limitations.............. | 2,283,858 | — | 1,138,003 |
| Default....................... | | 1,512,879 | |
| Included in adjusted pledged finance receivable figures are: | | | |
| Inadmissible amounts: | | | |
| Obligors in excess of $500,000..... | 16,395,000 | 16,364,000 | 15,651,000 |
| Adjusted total exceeding the limitations.................. | $14,111,142 | $ 17,876,879 | $ 14,512,997 |
| Say.......................... | $14,111,000 | $ 17,877,000 | $ 14,513,000 |

It will be noted that, even including the inadmissible amounts of receivables pledged by the Adelaide Street companies, the pledged finance receivables of the Atlantic group, as adjusted and properly stated, fall short of the required 115% of the principal amount of senior debt by over $1,500,000 at September 30, 1964, and that if the inadmissible receivables had been excluded, as they should have been, there would have been very substantial deficiencies at August 31, September 30 and December 31, constituting events of default. In relation to the other limitations on the amounts and types of finance receivables to be pledged, particularly those provided for in the fourth supplemental indenture to be reported on in the annual report for the fiscal year, Mr. James found no evidence indicating breach.

*(ii) Limitation under Section 6.12(2)*

The limitation confining the creation of senior debt to an amount not exceeding 350% "of the sum of (i) Consolidated Net Worth, less the book value of the fixed assets of the Company and its subsidiaries, at the time of such transaction, and (ii) the aggregate principal amount of Subordinated Debt at the time outstanding" was expressed in section 6.12(2) of the senior trust deed. The figures used in the calculation below reflect the position at August 31, September 30 and December 31, 1964, and are self-explanatory, showing consolidated net worth as adjusted according to the provisions of section 1.01, less the book values of fixed assets, the amount of the subordinated debt to be added to it, an expression of the 350% limitation and of the extent to which this limitation was or was not exceeded at the three month-ends.[5]

[5]Exhibit 3468.

CALCULATION OF SENIOR DEBT PERMITTED
IN TERMS OF SECTION 6.12 (2)

| No Senior Debt will be issued if the aggregate principal amount of all Senior Debt would exceed 350% of the sum of the Consolidated Net Worth (less fixed assets) and the aggregate principal amount of Subordinated Debt. | 1964 | | |
|---|---|---|---|
| | *August 31* | *September 30* | *December 31* |
| Net worth as per consolidated financial statements | $11,598,332 | $13,527,593 | $15,906,163 |
| Less amounts to reduce net worth to true equity value: | | | |
| (a) Cost of investment in subsidiary companies in excess of book values thereof | (941,335) | (941,335) | (1,075,145) |
| (b) Unamortized long-term debt financing expenses | (582,496) | (781,780) | (746,555) |
| Consolidated net worth—as defined Section 1.01 | 10,074,501 | 11,804,478 | 14,084,463 |
| Less specific deduction—Section 6.12 (2): Office equipment, automobiles and leasehold improvements—at book values | (138,508) | (135,967) | (133,682) |
| Consolidated net worth—as per Section 6.12 (2) | 9,935,993 | 11,668,511 | 13,950,781 |
| Less incorrect classification by the company: Short-term note #2416 for Great Northern Capital Corporation classified as capital stock | | (2,000,000) | |
| Adjusted consolidated net worth | 9,935,993 | 9,668,511 | 13,950,781 |
| Plus subordinated debt: | | | |
| (a) Aggregate principal amount outstanding | 14,393,139 | 14,426,889 | 14,260,993 |
| (b) Less short-term junior subordinated notes acquired by Cimcony with funds loaned to it by Atlantic | (1,080,000) | (1,080,000) | — |
| | $23,249,132 | $23,015,400 | $28,211,774 |
| Limitation is set at 350% thereof: | $81,371,962 | $80,553,900 | $98,741,209 |
| Senior Debt: where notes in U.S. dollars have been converted "at the rate of exchange in effect at the time of the original issuance" Section 2.02 (excluding interest) | 83,937,216 | 89,610,030 | 92,467,525 |
| Limitations of Section 6.12 (2) exceeded by: | $ 2,565,254 | $ 9,056,130 | — |

The important part played by the addition of the outstanding amount of the Cimcony of Canada notes to the subordinated debt, and of classification of the Great Northern Capital Corporation short-term note for $2,000,000 as capital stock for the purposes of the quarterly report, can easily be seen. The words "(excluding interest)" require special comment. In previous calculations it has always been the principal amount of the senior debt which has been considered, just as in the case of this calculation the principal amount of the subordinated

debt is to be added to consolidated net worth. However, the prohibition in this section is against the creation of "senior debt" in excess of the limitation, and section 1.01 of the senior trust deed defines "senior debt" as including "all debt of the company (except subordinated debt) not prohibited by the provisions of section 6.12(2) . . .". "Debt" means *inter alia* "all obligations and liabilities in respect of borrowed money, which . . . would be classified as liabilities on the balance sheet . . . .". There would thus be included, in the calculation of senior debt allowed to be created, interest accrued at any time on the senior debt already outstanding. Mr. James was mindful of the fact that senior debt could not be created if "the aggregate principal amount of consolidated debt at the time of such transaction" exceeded 350% of the sum of consolidated net worth and the aggregate principal amount of subordinated debt, but, since the company had already created it, the extent to which there had been a breach of the limitation can only be properly measured by adding to it the amount of the accrued interest which is excluded from the figures given above. Here again, because of the complexity of the definitions given in the deeds of trust, Atlantic Acceptance was given the benefit of any doubt arising from the expression "the principal aggregate amount of senior debt outstanding." Mr. James's calculation of the accrued interest for the three dates is as follows:[6]

ATLANTIC ACCEPTANCE CORPORATION
TRUST INDENTURE
ACCRUED INTEREST

| | August 31, 1964 | | September 30, 1964 | | December 31, 1964 | |
|---|---|---|---|---|---|---|
| *Senior Debt.* | | | | | | |
| Short term notes | | | | | | |
| Cdn. | $106,770.16 | | $ 82,393.12 | | $62,314.04 | |
| U.S. | 115,546.47 | | 71,155.09 | | 28,228.92 | |
| Exchange | 9,243.72 | | 5,692.41 | | 2,081.88 | |
| | | $231,560.35 | | $159,240.62 | | $ 92,624.84 |
| Bank loans | | 2,166.10 | | 1,969.18 | | 3,583.90 |
| Medium term notes | | 142,140.00 | | 23,175.04 | | 92,642.99 |
| Long term notes | | 368,713.54 | | 464,530.15 | | 694,704.60 |
| | | 744,579.99 | | 648,914.99 | | 883,556.33 |
| *Subordinated Debt.* | | | | | | |
| Series 1-4 | 221,203.95 | | 282,071.40 | | 97,442.10 | |
| Jnr. Subordinated | 24,965.75 | | 29,495.96 | | 20,913.54 | |
| | | 246,169.70 | | 311,567.36 | | 118,355.64 |
| Total Accrued Interest | | $990,749.69 | | $960,482.35 | | $1,001,911.97 |
| *Shown on Financial Statement as* | | | | | | |
| Accrued interest | | $988,583.59 | | $958,513.17 | | $ 998,328.07 |
| Included in Accrued Liabilities | | 2,166.10 | | 1,969.18 | | 3,583.90 |

[6]Exhibit 3467.

In any event Atlantic Acceptance succeeded in concealing the events of default which should have been apparent at August 31 and September 30, and by December 31, 1964 was able to report correctly, with respect to this limitation, a state of affairs involving no breach of the covenant in section 6.12(2).

*(iii) Subordinated Debt*

It has previously been observed that subordinated debt was more difficult to create in that subordinated notes were less easy to sell and more costly to service, compared with senior notes and preferred and common stock. C. P. Morgan had also been confronted, early in 1965, with the proviso in the deed of trust securing the subordinated notes that the company's earnings must be not less than three times the amount of interest payable on subordinated debt. No doubt for these reasons alone there was no breach of the limitation restricting the creation of subordinated debt to not more than 150% of consolidated net worth, as the following figures show:[7]

CALCULATION OF SUBORDINATED DEBT
PERMITTED IN TERMS OF SECTION 6.12(2)

The aggregate principal amount of outstanding Subordinated Debt is not to exceed 150% of Consolidated Net Worth.

| | 1964 | | |
|---|---|---|---|
| | *August 31* | *September 30* | *December 31* |
| Consolidated net worth defined Section 1.01 . . . | $ 9,974,501 | $11,804,478 | $14,084,463 |
| Less: | | | |
| Short term note #2416 in favour of Great Northern Capital Corp. shown as capital stock . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | — | 2,000,000 | — |
| | 9,974,501 | 9,804,478 | 14,084,463 |
| Adjusted consolidated net worth at 150% . . . . . . | $14,961,751 | $14,706,717 | $21,126,694 |
| Subordinated Debt | | | |
| Aggregate principal outstanding . . . . . . . . . . . . | $14,393,139 | $14,426,889 | $14,260,993 |
| Included therein are two junior subordinated short term notes in favour of Cimcony of Canada financed out of Atlantic's funds and not issued under the junior subordinated trust deed . . . . . . . . . . . . . . . . . . . . . . . . . . . | (1,080,000) | (1,080,000) | — |
| | 13,313,139 | 13,346,889 | 14,260,993 |
| From the above the subordinated debt is within its limits: | | | |
| Even when we consider accrued interest thereon . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | 246,170 | 311,567 | 118,356 |
| | $13,559,309 | $13,658,456 | $14,379,349 |

*(iv) Junior Subordinated Debt*

Junior subordinated debt at June 17, 1965 amounted to not more than $4,351,679, inclusive of accrued interest, and had never amounted to as much as 50% of the alleged consolidated net worth, much less the permitted limit of 100%.[8]

[7]Exhibit 3470.
[8]Exhibit 545.

## The Business Corporations Act 1968—Indenture Trustees

Before leaving the subject of the deeds of trust, and the part they played in giving a false sense of security to investors in the securities of Atlantic Acceptance, close attention must be paid to important legislative changes proposed by the government of Ontario in the shape of the Business Corporations Act 1968, introduced into the first session of the Twenty-eighth Legislature of Ontario and read for the first time on May 17, 1968. This bill, also known as Bill 125, because of the far-reaching nature of its provisions covering nearly every aspect of corporation law and practice, was not proceeded with in that session, and at the time of writing[1] has not been re-introduced. I have had occasion to comment on some of its provisions in Chapter XVIII,[2] which deals mainly with the subject of C. P. Morgan's private fortune, but also with the conduct of the directors of Atlantic Acceptance, and it is in connection with the latter subject that I felt attention should be drawn to the serious situation in which company directors might find themselves if the bill became law in its present form. The bill also deals, under the heading of "Indenture Trustees", and by sections 56 to 61 inclusive, with the subject of trust indentures "by the terms of which a corporation issues debt obligations and in which a trustee is named as trustee for the holders of the debt obligations issued thereunder", and these sections, like many others, seem to have been inspired by the great and natural public concern occasioned by the failure of Atlantic Acceptance Corporation in 1965 and that of the smaller Prudential Finance Corporation in 1966. For the purposes of convenience and ready reference that portion of the proposed legislation which, like the whole bill, is still under study, is set out below:

*"Indenture Trustees*

Interpretation

**56.** In this section and in sections 57 to 61,

*(a)* 'trust indenture' means any deed, indenture or document howsoever designated, including any supplement or amendment thereto, by the terms of which a corporation issues debt obligations and in which a trustee is named as trustee for the holders of the debt obligations issued thereunder;

*(b)* 'trustee' means any person named as trustee under the terms of a trust indenture, whether or not the person is a trust company authorized to carry on business in Ontario. *New.*

Conflict, question of fact

**57.**—(1) For the purposes of this section, conflict of interest is a question of fact to be determined by the circumstances of each case.

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[1]April 1969.
[2]pp. 1510-2.

Contents of trust indentures

(2) Trust indentures to which a corporation is a party as an issuer or guarantor of debt obligations and trust indentures that are expressed to be governed by the laws of Ontario shall contain or, if they do not, shall be deemed to contain provisions substantially to the following effect:

1. In the exercise of the rights, duties and obligations prescribed or conferred by the terms of the trust indenture, the trustee shall exercise that degree of care, diligence and skill that a reasonably prudent trustee would exercise in comparable circumstances.

2. A person shall not be appointed a trustee under a trust indenture if a conflict of interest exists in the trustee's role as a fiduciary thereunder, and a trustee under a trust indenture shall resign from office in the event that a conflict of interest subsequently arises.

3. In the exercise of his rights, duties and obligations the trustee may, if he is acting in good faith, conclusively rely, as to the truth of the statements and accuracy of the opinions expressed therein, upon certificates or opinions conforming to the requirements of the trust indenture if the indenture contains provisions complying with section 58.

4. The trustee shall be required to give to the holders of debt obligations issued under the trust indenture, within thirty days after the occurrence thereof, notice of every event of default arising under the trust indenture known to the trustee unless the trustee in good faith determines that the withholding of such notice is in the best interests of the holders of the debt obligations and so advises the corporation in writing. *New.*

Provisions which trust indentures must contain

**58.**—(1) A trust indenture to which section 57 applies shall contain provisions substantially to the following effect:

1. The corporation that is the issuer or guarantor of the debt obligations issued under the trust indenture shall furnish to the trustee evidence of compliance with every covenant or condition specified in the trust indenture relating to,

   i. the certification and delivery of debt obligations under the trust indenture,

   ii. the release or release and substitution of property subject to any mortgage, charge, lien or other encumbrance created by the trust indenture,

   iii. the satisfaction and discharge of the trust indenture,

   iv. the issuing of additional debt obligations thereunder, and

   v. any other action or step required to be taken by the trustee under the trust indenture or as a result of any obligation imposed by the trust indenture.

2. Evidence of compliance referred to in paragraph 1 shall consist of,
   i. statutory declarations made by officers of the corporation authorized by the trust indenture stating that the covenant or condition has been complied with in accordance with the terms of the trust indenture,
   ii. an opinion of a solicitor that the covenant or condition has been complied with in accordance with the terms of the trust indenture, and
   iii. in the case of a covenant or condition compliance with which is subject to the review or examination by auditors or accountants, an opinion or report of the auditor of the corporation or any accountant licensed under *The Public Accountancy Act,* in each case approved by the trustee, as to the accuracy or reliability of the statements required to be reviewed or examined and whether or not the statements have been made in accordance with the terms of the trust indenture.

R.S.O. 1960, c.317.

3. A statutory declaration, opinion or report required under paragraph 2 shall include,
   i. a statement by the person making or giving such statutory declaration, opinion or report that he has read and is familiar with the covenant or condition,
   ii. a brief statement of the nature and scope of the examination or investigation upon which the statements or opinions contained in the statutory declaration, opinion or report are based,
   iii. a statement that, in the belief of the person making or giving the statutory declaration, opinion or report, he has made such examination or investigation as is necessary to enable him to express an opinion whether the covenant or condition has been complied with, and
   iv. a statement whether in the opinion of such person the covenant or condition has been complied with.

Additional provisions may be included

(2) Nothing in this section prevents the inclusion in a trust indenture of provisions requiring evidence of compliance with covenants or conditions in addition to those specified in this section. *New.*

Provisions which trust indentures must not contain

**59.** A trust indenture to which section 57 applies shall not contain any provision relieving the trustee from liability arising thereunder, except that under the terms of the trust indenture the trustee may conclusively rely, as to the truth of the statements and the accuracy of the opinions expressed therein, upon statutory declarations, opinions or reports conforming to the requirements of section 58 if the trustee acts in good faith and examines the evidence furnished to him under that section in order to determine

whether such evidence conforms to the applicable requirements of the trust indenture. *New.*

Trustees under trust indentures not to be appointed receivers, etc.

**60.** A trustee under a trust indenture to which section 57 applies and any related person to such trustee shall not be appointed a receiver or receiver and manager or liquidator of the assets or undertaking of the corporation that issued or guaranteed the debt obligations under the trust indenture. *New.*

Where s.s. 57-59 do not apply.

**61.** Sections 57, 58 and 59 do not apply to any trust indenture entered into before the coming into force of those sections. *New.*"

Before commenting on the effect of the proposed sections it should be said that they, in company with all of the 260 sections of the bill which was widely circulated to interested members of the public, were the result of the Interim Report of the Legislature's Select Committee on Company Law, appointed by resolution on June 22, 1965, or exactly a week after default by Atlantic Acceptance on the note given to S.F.C.I. became known. The Committee was reconstituted in 1966 and its chairman, Mr. Allan F. Lawrence, Q.C. (now Minister of Mines for Ontario) tabled its interim report in 1967 in the fifth session of the Twenty-seventh Legislature. The Committee's terms of reference were wide, and involved a review of the Corporations Act of the Province and related statutes, and consideration of "the principles of the incorporation, operation, management and dissolution of corporations, including co-operatives, together with the legislation of other jurisdictions relating to the same matters". The interim report consisted of some 150 pages, including appendices, and recommended sweeping changes in substance which, if adopted, will result in the obliteration of most of the jurisprudence which has been developed hitherto in the field of company law since Confederation. The Committee travelled widely and produced the interim report in a period which almost exactly coincided with the preparation and presentation to this Commission of the evidence dealing with the failure of Atlantic Acceptance Corporation. Many recent developments and proposals in foreign jurisdictions were considered, and in this respect an extract from the preface to the report may usefully be quoted.

> "Of all the materials of the various countries whose law and experience we reviewed, no materials received a closer examination and consideration than the federal and state laws of the United States. In particular, the Business Corporation Law of the State of New York and the Corporations Code of California were the subject of careful study by the Committee or its staff. The New York law was particularly prominent in our considerations because of the mammoth study undertaken by the Joint Legislative Committee to Study the Revision of Corporation Laws of the State of New York between 1958 and 1963, which culminated in the new Business Corporation Law of New York.

> Lastly, in the United States, we found the model statutes such as the Model Business Corporation Act and the Uniform Commercial Code, prepared under the auspices of the American Bar Association, to be of practical value."

Of particular interest is the Select Committee's preoccupation with the provisions of the Trust Indenture Act of 1939, enacted by the Congress of the United States in that year, the provisions of which are discussed in chapter XI of the interim report, entitled "The Role of the Trustee Under Trust Indentures", and quoted extensively in its Appendix D.

Section 57 of Bill 125, quoted above, adopts the well-tried expedient of prescribing what a deed of trust shall be deemed to contain, even though the parties to it have not expressly adopted the prescribed provisions. Paragraph 1 of subsection (2) is apparently only declaratory, and at first glance would appear to have overlooked the existence of courts of equity in which any failure by a trustee to observe the standards developed over the last four hundred years may be brought home to him. Nevertheless, when read in conjunction with section 59, it will be seen that it strikes at the roots of all those saving clauses which have commonly been introduced into deeds of trust to reduce the trustee's liability thereunder, and to make his function largely formal and the performance of it as economical as possible. An example of these saving provisions may be seen under Article XVIII of the Atlantic Acceptance composite indenture, headed "Administration of the Trust and Protection of the Trustee".[3] Indeed the Select Committee quotes at considerable length from the report of the United States Securities and Exchange Commission made to Congress in 1936, upon which the Trust Indenture Act of 1939 was based and in which the attack on saving clauses was first mounted, although it prefaces its quotation by saying that it "is conscious of the fact that the practices and abuses concerning trustees under trust indentures as they existed in the United States thirty years ago are not, either in degree or kind, necessarily duplicated in Ontario today . . . .". As an example of the difficulties which may confront a trustee in this capacity under the proposed legislation, an important decision required of him under paragraph 4 of subsection (2) of section 57 as to whether or not holders of debt obligations under a trust deed should be advised of an event of default by a borrower, which is evidently within his discretion if he acts in good faith, apparently exposes him to liability by the operation of section 59. I say "apparently" because I do not wish either to suggest or anticipate interpretations which may be made by the courts in future on the effect of statutory provisions of this nature; let it suffice that all the deeds of trust which have been examined exonerate the trustee from any liability arising from the exercise of his discretion in the circumstances provided for by their terms. The consequences of thus exposing a trustee to liability in Ontario may well be

[3]Appendix K.

similar to those which began to appear in the United States as a result of the Trust Indenture Act, and of these more must be said.

Paragraph 2 of the second subsection of section 57 is less easily explained than paragraph 1 and must inevitably provoke astonishment. It deals with the important question of conflict of interest, and it will be observed that a trustee is disqualified if a conflict of interest exists in his "role" as a fiduciary under the terms of the deed of trust, either at the time of the execution of the deed or afterwards; whenever a conflict of interest arises he must "resign his office". The important question of what constitutes conflict of interest, and upon the answer to which would depend the maintenance or disruption of many complicated business arrangements, is nevertheless not answered, unless the words of subsection (1)—"for the purposes of this section, conflict of interest is a question of fact to be determined by the circumstances of each case"—can be so considered. The authors of the American statute grappled with the difficult task of definition in section 310(b) of the Trust Indenture Act, providing nine comprehensive examples, all of which are quoted in Appendix D to the Select Committee's report; but that body simply confined itself to the following comment, faithfully followed by the draftsman of Bill 125:

> "In the opinion of the Committee it is not necessary to define 'conflict of interest' as is the case, in effect, in section 310(b) of the Trust Indenture Act as there is no evidence before the Committee that indenture trustees in Ontario have failed to discharge their fiduciary obligations because of the existence of any of the relationships proscribed by that Section. What is or is not, as a matter of fact, a conflict of interest should be clearly discernible in the great majority of cases."

Assuming that most conflict of interest situations are clearly discernible, an assumption belied by all the experience of courts of equity, the question must still be asked: discernible by whom? The trustee? The holders of debt obligation? The absence of any provision for arbitration or reference to the courts is remarkable. The proposed legislation simply leaves trustee and bondholders to their own devices and offers strong temptation to the trustee to bid the latter good-day and resign, as it is said, his "office". What then becomes of the elaborate structure of covenants, permitted ratios of debt, and other profound calculations under which thousands and perhaps millions of dollars of debt have been created? *Quis custodes ipsos custodet?* I must conclude, with all deference to the draftsman of the Select Committee's report and the draftsman of these sections of Bill 125, that the nature of the relationship existing between a corporate borrower, the lenders to it and its trustee under a trust indenture, has been misconceived. Some signs of this are perhaps apparent in the use of such words as "rôle", with reference to a trustee's obligations as a fiduciary, and "office" from which he must

"resign" when the clearly discernible conflict of interest arises. A fiduciary does not play a rôle nor a trustee take office, and these examples of the vernacular are not becoming to an Ontario statute. Moreover a deed of trust or trust indenture, whatever it may be called, is a conveyance of property, specifically mortgaged or charged or subject to a floating charge in favour of the trustee who is a grantee under the conveyance and, like any other mortgagee, bound to reconvey after repayment of the debt and performance of the covenants created. The mortgage or charge might well be made in favour of the lenders, or "holders of debt obligations", were it convenient to do so, but the trustee is interposed between them and the borrower, or "issuer of debt obligations", to place the security and the task of enforcing it, should need arise, in one pair of hands. The relationship has been created and refined as an aid to business transactions, not as a solemn exemplification *in vacuo* of the law of trusts. When it ceases to be convenient for the purpose to which it has been adapted it will quickly go out of fashion; in the meantime its mutuality must be preserved, and a trustee under a deed of trust cannot be permitted to walk out of it at will any more than can a mortgagee, even though he clearly discerns that some interests, unspecified in the proposed legislation, conflict in a manner for which no remedy is provided. Clearly this provision of section 57 of Bill 125 must be reconsidered, if only to allow some acceptable method of relieving a trustee of his obligations and setting aside a conveyance upon which many hopes have been built, without exposing its parties to inconvenience and loss arising from the unilateral decision of one of them.

Paragraph 4 of the second subsection of section 57 provides that a trustee, if acting in good faith, may conclusively rely on certain certificates or opinions required to be given by the provisions of section 58, which again are to be deemed to be incorporated in any deed of trust of the type here being considered. This section may well cause concern both to officers of corporations borrowing in the money market and to officers of corporate trustees who assist them, and have some precise knowledge of the numbers of pieces of paper handled in the course of undertaking "the certification and delivery of debt obligations under the trust indenture", and "the release or release and substitution of property subject to any mortgage, charge, lien or other encumbrance created by the trust indenture". It has already been seen in the case of Atlantic that in 1964 transactions contemplated by this language amounted to as much as 8,000 in the course of a month, and this finance company was by no means the largest carrying on business in Ontario. It appears from paragraph 2 of this section that each of these transactions could require a statutory declaration made by an officer of the borrowing company and the opinion of a solicitor as to compliance with at least one, and perhaps more of the covenants of the deed of trust. For example, if the Atlantic trust deeds are to be considered

as typical, each "release or release and substitution of property" would be accompanied by such a statutory declaration and a solicitor's opinion as to compliance with covenants relating to the permitted debt ratios, the ratio of 115% relating to the amount of specific receivables to be pledged against the issue of senior notes, a restriction on pledging of receivables of any one obligor in an amount over $500,000 and other restrictions as to the limitation on the pledging of receivables arising from different categories of a company's finance business, all in connection with the lodging and withdrawal of many thousands of promissory notes. Then, if any deed of trust requires a certificate from the borrowing company's auditors that in the course of their audit they have obtained no knowledge of a breach of any covenant therein which might constitute an event of default, it is possible, but, one may hope, not probable, that each of these transactions would require a certificate from the auditor as well. It will be seen that, by the terms of paragraph 3 of section 58, the statutory declaration, opinion or report required is by no means perfunctory. The possibility, and indeed likelihood of large numbers of statutory declarations, opinions and reports being required every month, at heavy expense in professional fees, should not be overlooked when considering the practical application of the proposed legislation, well-intentioned though it may be.

Section 60 prohibits the appointment by the court of a trustee under a deed of trust as receiver, or receiver and manager, or liquidator of the assets or undertaking of the corporation which issued or guaranteed the secured debt obligations, and presents a problem of a different kind. It was evidently inspired by the situation in which the Montreal Trust Company found itself, as trustee for noteholders of Atlantic Acceptance in all three categories of debt, senior, subordinated and junior subordinated, when it applied to and was appointed by the Supreme Court of Ontario as receiver and manager of Atlantic Acceptance and all its subsidiary companies. It quickly formed the opinion, forced upon it indeed by the logic of events, that realization upon the security which it had in its hands as trustee, and subsequently acquired as receiver, could only suffice to satisfy the claims of the senior secured noteholders, and these only in part. This conclusion was published in its reports to all the noteholders who were its beneficiaries, and provoked independent action by holders of subordinated debt resulting in the commencement of litigation, still pending and designed to invalidate senior notes issued after June 1, 1963, on the grounds that an event or events of default had occurred before they were authenticated by the trustee. Montreal Trust is a defendant in this action and its duties as receiver and manager have been hampered by the necessity of postponing distribution of the very large sums realized by the disposal of Atlantic assets until the matter is settled, perhaps only after a trial and successive appeals which may well be still in progress long after the

appearance of this Commission's report. The conclusions of the Select Committee are taken from the same chapter XI of its report which has previously been considered.[4]

> "11.1.6. During the last 25 years or so, the practice has grown up in Ontario and elsewhere in Canada whereby the receiver or receiver and manager appointed by the court, in the event of default under indentures securing obligations, whether on the application of the company or a creditor, is frequently the trustee under the indenture securing the obligations in default. In very many cases the company consents to the appointment of the indenture trustee as receiver or receiver and manager. A receiver duly appointed by the court is an officer and representative of the court. A receiver should be wholly disinterested in the subject matter of the receivership. The practice of appointing the indenture trustee as receiver or receiver and manager is, accordingly, a reprehensible practice which should be discontinued, as the indenture trustee is under a fiduciary obligation with respect to the holders of the obligations issued under the indenture. As stated in Kerr:
>
> > 'The two characters of trustee and receiver are rarely compatible, and, in addition to this, the appointment of a trustee to act as receiver is, unless he undertakes to act without remuneration, a violation of the rule of equity that a trustee cannot derive any benefit from the discharge of his duty as trustee. The court will even remove a receiver whose private interests are in conflict with his duties, notwithstanding that his acts may for the most part have been for the general good of the property, and that a majority in number and value of the incumbrancers on it may desire that he be retained.'
>
> In order to ensure that the recommendations in paragraph 11.1.4(e) as to the avoidance by indenture trustees of conflicts of interests are fully effective, the Committee suggests that the new Part of the Act recommended in paragraph 11.1.4 should contain a prohibition against an indenture trustee being appointed as receiver or receiver and manager of the assets of the company which issued or guaranteed the obligations issued under the indenture."

The eye of the reader must inevitably be caught by the use of the phrase "reprehensible practice", applied, as it is, by the author of this section of the report, to orders of the Supreme Court of Ontario. The Shorter Oxford Dictionary, itself a very substantial condensation of the Oxford Dictionary of the English Language, defines "reprehensible" as "deserving of reprehension, censure or rebuke; reprovable; blameworthy". It may be thought that this is strong language to use about an order of the highest provincial court which even the dissident noteholders have not sought to set aside. It is to be hoped that its use can be attributed to deficiency of either taste or literacy, and not to a deliberate desire to scandalize the court. Nevertheless, there is, in this paragraph of the report, evidence of bias which may be inadvertent.

[4] Interim Report of the Select Committee on Company Law, Ontario, 1967.

The quotation prefaced by "as stated in Kerr" is taken from and attributed to the thirteenth edition of the well-known authority on receivers and receivership,[5] and has been boldly lifted from its context in chapter IV of that work, entitled "Who May be Appointed Receiver". The words immediately preceding it, under the subheading "Trustee", read as follows:

> "It is not according to the usual course of the court to appoint a trustee to be receiver, although a trustee with no active duties to perform, or with powers not yet exercisable is sometimes appointed. The court, on appointing a receiver of a trust estate, looks to the trustee to see that the receiver is doing his duty."

The passage quoted by the Select Committee is followed by a sentence saying that "the rule against appointing a trustee to be a receiver applies whether he is a sole trustee or is acting jointly with others", then proceeds to a new paragraph.

> "In special cases, however, where the appointment of a trustee to be receiver will be beneficial to the estate, as, for instance, where he has a peculiar knowledge of the estate, or no one else can be found who will act with the same benefit to the estate, the court will make the appointment. He may be required to undertake to act without remuneration. Remuneration is not usually allowed to a trustee acting as receiver, but there is no inflexible rule against the allowance of remuneration."

Any one reading the extract quoted in the interim report, bracketed by the quotations given above from which it has been divorced, will see that the apparently strong statement relied upon by the Select Committee is considerably ameliorated if the passage is read as a whole, and a much better understanding of the danger inherent in quoting an authority on the law of a foreign jurisdiction will be obtained by the reader who consults the whole work of the learned author. If, for example, the draftsman of the Select Committee's report had undertaken to quote the section of the same chapter of Kerr entitled, "In Company Cases", he would have found on page 109 the flat statement: "A body corporate is not qualified for appointment as receiver of the property of a company formed and registered under the Companies Act 1948 or preceding Companies Acts. Any such purported appointment is a nullity". Thus he would have seen, and might have felt bound to disclose, that the section of "Kerr on Receivers", an eminent English authority on which the Select Committee has relied, is not dealing at all with corporate trustees, who are in Ontario liable to no such disability and with whose qualifications the Committee was principally concerned. Further doubts might have been raised by the observation that "remuneration is not usually allowed to a trustee acting as receiver, but there is

[5]Kerr: The Law and Practice of Receivers, Ed. Raymond Walton M.A., B.C.L.: 13th Ed.; 1963 London, Sweet & Maxwell.

no inflexible rule against the allowance of remuneration", since the compensation allowed to the receiver of an estate as large as that of Atlantic Acceptance is, as has been seen in Chapter IV, no small element in any estimate of recovery by the noteholders. If the word "reprehensible" is to be used at all, it may be fairly applied to the type of editing of authorities which has been illustrated here, and which has no place in the preparation of a public document.

The Select Committee freely acknowledged its debt to American innovation in the field of company law, but its interim report was silent on what has been the most significant result of the enactment of the Trust Indenture Act of 1939. The fact is that in the past twenty years the practice of securing issues of bonds or notes by finance companies by a deed of trust given to a trustee for the lenders has significantly declined in the United States and continues to do so. The explanation for this, given on all sides to this Commission, is that the provisions of the Trust Indenture Act laid burdens upon a trustee which could only be accepted for compensation beyond the capacity of a borrower to give if its securities were to compete successfully with those of others in the money market. It is now a common practice in that country for borrowers to furnish lenders with a prospectus and an agreement containing, amongst others, a simple covenant to repay, and this new procedure has been found to be convenient and better adapted to the needs of the market-place than that which Congress sought to regulate by the Trust Indenture Act. Experienced observers of the American scene are now also of the opinion that the abandonment of the deed of trust as an instrument of security has the positive advantage of putting lenders on their mettle, and of discouraging reliance upon guarantees which have in many cases proved to be illusory. It may well be that the American experience of the past twenty years will be repeated in Ontario, and that the attempt to impose more onerous obligations on trustees under deeds of trust, albeit made in the public interest, will be abortive for the same reasons. It would be inconvenient if this were so, since the security offered by a deed of trust is real, and fully disclosed to anyone who chooses to examine it and take competent advice about the effect of its provisions. There is an added advantage, foreshadowed in Chapter XV of this report dealing with the affairs of British Mortgage & Trust Company, in encouraging Ontario trust companies to perform the useful function of trustee to a greater extent than heretofore. The fate of the American Trust Indenture Act must inevitably be the fate of all serious efforts to interfere with freedom of contract in a free society, unless resolutely forestalled by imposing more restrictions upon it. If the provisions of Bill 125, which have been here discussed, are to escape that fate, legislation might provide that all public borrowing by business corporations be secured by deeds of trust of the type contemplated; but, if such a mandatory provision were made, finance companies and other

corporations in Ontario, and such parts of Canada as may elect to adopt Ontario legislation in principle if not in detail, would be at a serious competitive disadvantage in a money market which transcends provincial and national boundaries. The tendency of the Select Committee to ignore the discernible results of legislation based on American precedents in the case of trust indentures has been matched by its predisposition to copy the legislation of the State of New York, whereby company directors have been exposed to derivative actions by shareholders, also conceived, with the best intentions, in the public interest, and productive of many extortionate and vexatious proceedings which have added to the cost and reduced the amenities of doing business in that jurisdiction. This aspect of Bill 125 is, as already noted, discussed in Chapter XVIII.[6]

When all this has been said, two additional observations must be made. In the first place, criticism of the recommendations of the Select Committee on Company Law as translated into the bill entitled "The Business Corporations Act 1968"—and they have been faithfully translated indeed—must not obscure the value of the many important proposals which have been made, particularly in connection with the practice and procedure of auditors. In the second, it is suggested that the real conflict of interest to be guarded against is not created by the appointment of a trustee under a trust indenture as receiver of the issuer of obligations, which can be safely left to courts of competent jurisdiction, and is invariably contemplated with favour by the holder of those obligations because of the special qualifications of the trustee; it rather arises from a selection of the same trustee to act for holders of different layers of debt. Here there are apt to be competing claims in a situation where large amounts of money are involved and serious loss has been inflicted, and where there are competing claims there should be separate trustees to bring them. It is accordingly recommended that any legislative changes include a provision that the same trustee should not act on behalf of both senior and subordinated noteholders, as was the case with Atlantic Acceptance. Such a recommendation must be accompanied by one of equal strength that no limitations be placed on the exercise of the discretion of the court to appoint a trustee under a trust indenture as receiver when the circumstances of the case warrant it. The swift action of the Montreal Trust Company, informed as it was of all the details of the legitimate business of Atlantic Acceptance, taken in June 1965, undoubtedly saved that company from bankruptcy and a much greater loss of assets than in fact occurred. It was action, moreover, which it was not bound to take, since it was empowered under the deeds of trust to liquidate forthwith.

[6] pp. 1510-3.

# CHAPTER XVII

# *The Riddle of the Accounts*

## A Change of Auditors

The decision to engage new auditors for Atlantic Acceptance Corporation from among nationally-known firms of chartered accountants, long advocated by Alan T. Christie and A. C. Rooney as representatives of Great Northern Capital Corporation on the finance company's board, was taken in June, 1964. It will be recalled that hitherto the audit had been conducted by Wright, Erickson, Lee & Macdonald of Hamilton, Ontario; their senior partner Mr. Harold P. Wright, F.C.A. had been a friend of C. P. Morgan with whom he played golf at Burlington, and the first offices of Atlantic Acceptance had been situated in the same building as the offices of his firm. This change had been resisted by Morgan, himself a chartered accountant, who had no reason to complain of the services of the Hamilton firm until the qualification of their opinion of the financial statements for 1963.[1] There was, however, another consideration involved; the firm selected was Deloitte, Plender, Haskins & Sells who had offices across Canada and were thus in a position to conduct the audit in relation to the many branches of Atlantic Acceptance outside the Province of Ontario more expeditiously and perhaps more economically; they were as well auditors for Great Northern Capital Corporation of which Atlantic was a subsidiary. Apart from the high reputation of Deloitte, Plender, Haskins & Sells (known as Deloitte, Plender, Griffiths & Co. in Great Britain and Haskins & Sells in the United States), the decision to appoint the auditors of a parent company to discharge the same function for a subsidiary company must be regarded as prudent and, to the mind of a layman, almost essential. Here,

[1]p. 69.

however, it should be observed that the accounting profession has long pondered the effect on those of its members, engaged in practice on a more modest local scale than the large firms, of being deprived of an auditing function simply because a corporate client has been absorbed in one of the "take-over" transactions which are common occurrences today, and has reached settled and humane conclusions about the competence and integrity of the small practitioner. Since a large portion of this chapter must be devoted to the standards of professional conduct in the accounting profession, it is important to notice at this point the creditable reluctance of members of the Institute of Chartered Accountants of Ontario, and indeed of those of similar provincial institutes guided by the Canadian Institute of Chartered Accountants, to disparage the abilities of their brethren, and a complementary tendency to observe the golden rule in their professional relationships.

Mr. James G. Duncan, F.C.A., the partner in the firm of Deloitte, Plender, Haskins & Sells who was in charge of the audit of Atlantic Acceptance, gave evidence before the Commission on November 8, 1966. He testified that although the appointment of his firm took effect on June 30, 1964 at the annual meeting of Atlantic shareholders, because of the one hundred separate offices of the company being in widely separated parts of Canada it was necessary to plan the audit for 1964 as soon as possible. His knowledge of the appointment was derived only from informal communications made by Rooney and C. R. Sherrill to other partners in the firm and he felt bound to wait for formal notification from the company before proceeding. After four weeks of uncertainty he telephoned C. P. Morgan who confirmed the appointment, but said that he was for the moment too busy to discuss the engagement. A meeting with the president of Atlantic Acceptance was postponed several times for the same reason and did not take place until October 14. Here Mr. Duncan may be allowed to speak for himself.[2]

> "Q. So far in your conversations with Mr. Rooney—I use 'you' in the sense of the firm and your own personal conversations with Mr. Morgan—what did you believe was going to be the scope of your audit?
> A. Until October 14th when we were finally successful in interviewing Mr. Morgan we thought we were going to be doing the complex.
>
> Q. Now, you spoke to Mr. Morgan possibly the end of July or early part of August. What transpired then so far as it concerned the receipt of the instructions you required?
> A. Perhaps I don't understand.
>
> Q. Did he call you back or did you have to make further calls or approaches of any kind?
> A. No, all the approach came from us.

[2]Evidence Volume 79, pp. 10695-702.

Q. What was the next thing you did then?

A. Call again trying to make another appointment after the lapse of time that he had deferred in the first call.

Q. And to shorten your evidence a bit, were there several such attempts?

A. Yes, there were.

Q. And they ultimately led to what?

A. A meeting October 14th at Mr. Morgan's office.

Q. Who was present at that meeting?

A. Mr. John Bennett, one of my partners, Mr. John Bailey and myself, with Mr. Morgan.

Q. What transpired at that meeting?

A. He informed us for the first time that there were certain companies that we were not going to be the auditors of and that the reason, therefore, is that we were, in fact, replacing Wright, Erickson and Lee on the portion of the work they had done with the addition of two virtually unknown active companies that had previously been done by the Wagman firm.

Q. That is Pay As You Study and Concourse Agencies?

A. Yes.

Q. Did he state why he was continuing the practice of having other auditors report on certain subsidiaries?

A. He used the word "commitments", that there were commitments that prevented this. He said, furthermore, that in due course that we would, no doubt, become the auditors of these other companies.

Q. Did he indicate over what period of time you might expect to replace the others?

A. So far as I can recall no time was mentioned.

Q. Did he indicate whether all the other companies would still form part of the Atlantic group and still be active?

A. No. He did say that some of them at least were going to be wound up.

Q. Did he specify which ones he envisaged would be wound up?

A. He did not.

Q. Is there anything else material at that conference? I suppose you discussed the scope of the audit you were going to do and the manner in which you were going to do it and the like?

A. Yes. He did ask that after we had made our preliminary survey of the company and had devised our branch audit program that he wished to discuss it with our partners.

Q. I take it this was a commonplace arrangement?
A. Quite customary.

Q. Now, you would then, I suppose, get in touch with the Wright firm, would you?
A. Yes, our professional ethics required that and we did write to them. The nature of the request is merely if they knew of any reason why we should not accept this engagement.

Q. Is this the standard practice within the profession?
A. Yes, that is so.

Q. And I suppose you got a standard reply, did you?
A. That is right.

Q. Thereafter would there be discussions from time to time or the examination of their statements and the like with the Wright firm?
A. Yes. It is also the practice within the profession, at least so far as I know, that where an engagement changes hands the auditor who is being replaced usually provides every facility and co-operation to the incoming auditor. There is no reason why he should not, and the Wright firm were co-operative and let us pick from their files certain statutory information that we would need to prepare our preliminary files.

Q. Then you commenced the preliminary work of audit leading to the final audit work after the balance sheet had been prepared by the officers of the company at the end of the year?
A. That is right.

Q. How many persons in all would be engaged on the audit at its peak?
A. Well, we visited thirty branch offices. Normally each one of those would be one man; some of the larger, there might have been two. Then we would have a staff at Oakville. I think that in total we could probably say there were 25 to 30 of our people involved at different times.

Q. These are branch offices, I take it, of Atlantic Acceptance, as such, and Atlantic Finance, as such, is that correct?
A. That is right.

Q. Is 30 an unusually large number to visit when you are simply making a test?
A. Well, in our opinion and based on our other experience, there were for that year a hundred offices in total.

Q. Yes.
A. And 30% is a bit above your average test. The reason as we explained it to Mr. Morgan, was that it was a new company to us. We wanted to get a better look at their branch operations and perhaps in the future, after we had established certain things, it would be possible to reach, as some of our clients already had, a smaller percentage than that.

Q. What steps is it common to take in the selection of such branches and the advice to the officers of the company of what branches you have selected?

A. Well, the branch examinations are surprise examinations. The branches do not know when you are coming, or even which branches you are going to.

Q. Yes.

A. We inquired into and discovered something of the nature of each of the branches, the size of its operations, the type of business it was doing, whether it was finance or acceptance work, and how long it had been constituted as a branch and so forth.

We then made what we consider a statistical selection of these, to cover as many combinations of types as we possibly could.

Q. Do you then follow the practice commonly of discussing the selections you have made with officers of the company, to the end that you would assure yourself that you had included any branches about which the officers felt an unusual amount of concern and the like?

A. The only officer that we discussed our plans with—we did not discuss them, we showed to Mr. Morgan the list of the thirty branches that we had chosen. He did not know when we were going, nor was there any change in the list. He just looked at it and said "a large number" or something.

Q. Is it standard practice among accountants to take that step, to indicate to the senior officer of the company what branches they are going to examine?

A. Well, I know of a number of clients of this type where the president —it is like a lot of our other work. Sometimes you have to consult with the top man of the firm, but you do not want the information going down the line at all; it destroys the surprise element.

Q. Then I take it that you carried out your examination without further—

A. That is right, from there on there was no contact with Morgan."

Deloitte, Plender & Co. were therefore engaged to audit the accounts of only those companies which had hitherto been the responsibility of Wright, Erickson, Lee & Co., namely Atlantic Acceptance Corporation Limited and its subsidiary companies, Atlantic Finance Corporation Limited and Atlantic Acceptance (Toronto) Limited, which may be referred to as the Oakville companies, and two moribund companies previously audited by Walton, Wagman & Co., Pay As You Study Plan Limited and Concourse Agencies Limited; the other subsidiaries such as Commodore Sales Acceptance Limited, its own subsidiary Commodore Factors Limited and Adelaide Acceptance Limited, which may be referred to as the Adelaide Street group, remained in the hands

of Wagman, Fruitman & Lando, the Premier Finance Corporation in those of E. M. Sprackman, Siderson & Co. and Standard Discount Corporation with Stone, Anger, Conway & Stone for purposes of audit. Deloitte, Plender & Co. wrote to each of these firms advising them that they would be reporting on the consolidated statement to Atlantic Acceptance Corporation for the year ended December 31, 1964, and asked them for signed financial statements of the subsidiary companies for which they were responsible for use in the consolidation of the accounts, as is the usual practice. As to what transpired thereafter I shall rely again on the questions put by Mr. Shepherd and answered by Mr. Duncan.[3]

"What were your instructions from Mr. Morgan acting on behalf of Atlantic, as to the extent to which you were to rely upon the audited statements examined by these other auditors?

A. There were no such instructions or comments even.

Q. But did he tell you to rely on the others or—

A. He said that the others had—were going to continue to do the work that they had been doing, and I commented back to him at that point that obviously then we would have to word our opinion as we finally did, and he said that would be satisfactory.

Q. Then you did receive in fact balance sheets containing an unqualified opinion from each of these auditors, is that correct?

A. That is so.

Q. On receipt of the final statements, what did you do with them?

A. We used them in the consolidation. We obviously look at the statements first.

Q. Do you follow the practice and did you follow it here, of going behind the statement and examining the working papers of the auditor who prepared the statement?

A. No, we did not.

Q. Is that a general practice which you followed, or was it a practice limited to one case?

A. No, our firm's policy, for various reasons, is not to review the working papers of other firms in such a situation.

Q. To what extent is the examination of working papers of assistance; I mean, if one does go and examine them?

A. Well, that is a very difficult question, and the reason that we do not do this for other firms, is that you are invariably looking at this company that they audited through the eyes of another man. You have to presume, for example, that he is independent, that he is competent, or

[3]Evidence Volume 79, pp. 10703-9.

else what he has put down is not really evidence of what conclusion he has arrived at. We feel that there is no substitute for doing the work yourself really.

Q. What is the commonly accepted practice among accountants in Canada, or what was the commonly accepted practice at that time among accountants in Canada, as to the question of whether one looks behind the statement of the auditor of the subsidiary?

A. Even today, as far as I am aware, there is no requirement that you do. It is an optional procedure. I believe that some firms do, and I know that some do not. In many cases you get inquiries about items on the statements, and I should add, of course, that if in the inspection of their statements that had come to us there has been anything unusual for the type of companies that we understood these to be, we would have asked about the accounting treatment.

Q. I take it then you do look at their financial statements, not only to take the figures from them so that they will be consolidated, but also to satisfy yourself that on the face of the statement at least it appears that generally accepted accounting practice has been followed, is that correct?

A. That is so.

THE COMMISSIONER: In answer to counsel's question as to what the practice was then, you said: 'Even today it is optional'. Do I understand you to mean that it was optional then to look at working papers?

A. Well—

Q. When I say "then" I mean at the time material to your first audit?

A. I think very definitely yes, is the answer.

MR. SHEPHERD: Can you give an illustration of the type of entry which might be made upon a balance sheet which on its face would indicate to you that proper accounting practice was not followed?

A. Referring to the type of companies that we are presently discussing, you would invariably find allowances for bad debts, and if there was not such a deduction from the receivables on the balance sheet, you would be, well, rather curious.

Furthermore the item of deferred income, unearned income, these two items would have to appear in any factoring or finance company statement, or else a rather unusual situation would exist.

Q. Can you make tests, or is it necessary so to do from examining the statement of the subsidiary, to satisfy yourself that the method adopted by the auditors of the subsidiary in treating, say, unearned income, is substantially the same as the method adopted by the consolidating auditor, or is it necessary to do so in your judgment?

A. You cannot do it from the statements, no.

Q. You could calculate, I suppose, the ratio of the allowances for loss to the outstanding receivables and compare that?

A. Yes.

Q. Apart from the examination of the balance sheet for the purposes you have described, what conversations were held with the other auditors? Let us deal specifically with Mr. Wagman's firm, what conversations were had with them?

A. I do not think there were any with any member of our staff.

Q. When you are consolidating figures, I suppose it must, from time to time arise where the amount recorded by the subsidiary auditor as being owing does not coincide precisely with the amount recorded on the lending company's records, and in that case one would have to have a discussion?

A. Yes.

Q. I wondered if anything of that nature arose, even of the most formal kind?

A. Obviously inter-company accounts have to be reconciled, and I do not recollect that there was any problem in that area.

Q. I see.

A. Probably the officers of Atlantic Acceptance had already seen that these accounts were in agreement, which is also customary."

In due course the draft consolidated financial statements were prepared and taken to Morgan for a final conference. These had been cast, as Duncan said, in "a substantially different form of presentation than Atlantic had previously issued their statements", and some of the suggested presentation was considered acceptable by Morgan, while some was not. The most contentious part was in the wording of the auditors' certificate in which they suggested that there should be a reference to the percentage of assets and earnings of subsidiary companies, the accounts of which they had not audited, in relation to the whole, a procedure provided for, although not insisted on, in the "technical procedure manual" of Deloitte, Plender & Co., extracts from which were produced by the witness and entered in evidence.[4] One of the "standard form reports" taken from this manual reads as follows:

> "We have examined the consolidated balance sheet of Blank Company Limited and its subsidiary companies as at December 31, 1963 and the consolidated statement of income and earned surplus for the year ended on that date and have obtained all the information and explanations we have required. Our examination included a general review of the accounting procedures and such tests of the accounting records and other supporting evidence as we considered necessary in the circumstances, except for certain subsidiary companies whose accounts have been examined and reported on by other chartered accountants. The combined net assets and net earnings of these latter companies constitute approximately 24% and 20% of the respective consolidated totals."

[4]Exhibit 3626.

After suggesting this as an appropriate form for the auditors' report in the case where the statements of a parent company and its subsidiaries are consolidated, the manual proceeds to say:

> "If the accountants are known to us as reputable, or if the results of our inquiry concerning them are satisfactory, we should say, substantially, that we have examined the financial statements of the companies except those of certain subsidiaries (named or described), which have been examined by other accountants (usually not naming them), that we have been furnished with the reports of those accountants, and that our opinion, insofar as it relates to the amounts included in the consolidated statements for those subsidiaries, is based on the reports of the other accountants. It sometimes is desirable to add that the total assets and gross revenues or net earnings (using appropriate language) of those companies represent such and such percentages of the totals shown by the consolidated financial statements, or that they are substantial (if that is the case) in relation to the consolidated totals; usually, however, we need not insist on this."

Extracts from their working papers[5] indicate that the accountants working on the audit did indeed contemplate such an insertion as the technical procedure manual provided for, and that it was suggested in addition that the names of the subsidiary companies to which the Deloitte, Plender & Co. auditing engagement did not extend should be given. Mr. Duncan's evidence briefly and clearly records the results of this suggestion and the reasons for Morgan's objection which appeared to him to be acceptable at the time.[6]

> "Q. Then is it the position that at first, according to your working papers, the firm contemplated referring to certain other subsidiaries respecting which you relied upon the statements examined by other auditors and you contemplated specifying in your certificate the proportion of net assets which the assets of those subsidiaries not reported on by you bore to the whole, is that correct?
>
> A. That was our suggestion.
>
> Q. Yes. Then you did not in fact do it, in that you omitted that portion of the certificate which specified the percentages of assets and profits from companies not reported on, is that correct?
>
> A. That is so. Mr. Morgan suggested, quite properly, that such additional percentages were not customary in Canada, and I have to agree with him. They certainly are not.
>
> Q. Did he give any other reasons for objecting to it, or did he limit himself to the observation that it was not Canadian practice?
>
> A. That was all he gave. He is, of course, a chartered accountant, perhaps—

[5]Exhibit 3490.1.
[6]Evidence Volume 79, pp. 10716-9.

Q. Did you yourself then form an opinion on whether or not it was Canadian practice to specify the percentage of assets in the companies not audited?

A. We certainly have strong opinions on that. As a matter of fact, I do not know of any examples where it is being used in Canada.

Q. Now, perhaps then you would wish to deal with the source of this particular procedure manual. Does it represent largely the American practice in this respect?

A. We study the American bulletins of course, and their pronouncements, and we feel that in some areas they are in advance of the Canadian. That is why we just, as in this example which I should say was not the only example of things which we tried to suggest to Mr. Morgan, we made the effort but had to take it out afterwards in resistance to it on the basis that it is not necessary.

Q. Did he not give any reason at all? It seems like largely a harmless clause. Did he not give any reason why he did not want it in there?

A. No, sir, he did not, and I can understand your feeling about the matter, because it is largely mine too, that it certainly would not have done any harm that I can envisage to him; but it is our common experience in dealing with clients of all types that they dislike intensely any departure from precedent, what has been going on, or any change in wording of the auditor's reports.

Q. Would your practice vary if the proportion of assets of the company were different, that is, supposing for example you had not audited Atlantic Finance and suppose Mr. Wagman's firm had audited that company: then he would have been auditing more than you would have been. Would you then have followed your certificate or followed your practice?

A. Well, in that case we would not have done the consolidation. We will not report on any consolidated statement where we have not done the bulk of the underlying audit work.

Q. When you say 'the bulk' do you mean more than half of it?

A. More than half.

THE COMMISSIONER: More than half of what?

A. Of the assets and the earnings."

In the end the auditors' report dated February 10, 1965 read as follows:

"We have examined the consolidated balance sheet of Atlantic Acceptance Corporation Limited and subsidiary companies as at December 31, 1964 and the consolidated statements of income and retained earnings for the year ended on that date. Our examination included a general review of the accounting procedures and such tests of accounting records and other supporting evidence as we considered necessary in the circumstances, except for certain subsidiary companies,

whose accounts have been examined and reported on by other chartered accountants.

In our opinion, which insofar as it relates to the amounts included for subsidiary companies whose accounts have not been examined by us is based solely on the reports of other chartered accountants, the accompanying consolidated balance sheet and consolidated statements of income and retained earnings present fairly the financial position of the companies as at December 31, 1964 and the results of their operations for the year ended on that date, in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

### Responsibility of Deloitte, Plender, Haskins & Sells

Two questions arising from this evidence must be considered. In the first place there was no doubt about the propriety of the report made by the Deloitte firm on the consolidated statements of Atlantic Acceptance Corporation for the year ended December 31, 1964. In this connection the Committee on Accounting and Auditing Research of the Canadian Institute of Chartered Accountants issued their bulletin No. 22 on Accounting and Auditing Practices in August, 1965, after the collapse of Atlantic and at a time when the extent to which generally accepted auditing procedures had been followed in the preparation of the Atlantic statements was under close examination. This bulletin, entitled "Reliance on other Auditors in Reporting on Consolidated Financial Statements", had been in course of preparation for many months and will be referred to at length hereafter. In the second place it is not difficult to imagine what would have happened if the auditors had taken the advice of their own manual and issued their report in the form they did, only after satisfying themselves of the good repute and reliability of the chartered accountants who had audited the financial statements of Atlantic's subsidiary companies. Had they done so they would have found that the firm of Wagman, Fruitman & Lando, auditors for Commodore Sales Acceptance, Commodore Factors and Adelaide Acceptance, had been constituted as such because the senior partner of its predecessor Walton, Wagman & Co., W. L. Walton, had left it as a result of an investigation by the Department of National Revenue (Taxation), leading to charges laid against him on October 20, 1964 of defrauding the revenue, notably by manufacturing for a fee false invoices on behalf of a client, on twelve of which he was ultimately convicted on November 29, 1965, resulting in his expulsion from the Institute of Chartered Accountants of Ontario on December 22.[1] Had they inquired further they would have found that earlier William L. Walton and William Wagman, his partner at that time and a brother

[1]Commission file: Institute of Chartered Accountants of Ontario—Certified Copy of Minutes of Meeting of Discipline Committee December 22, 1965.

of Harry Wagman, had been reprimanded by the President of the Institute at a meeting of its Council held on February 16, 1962, having acknowledged the correctness of charges brought against them by the Institute's Committee on Professional Conduct for breach of its rules, a meeting attended by their own senior partner, Mr. Clement L. King, F.C.A. The report and minutes of this meeting, although confidential, were circulated to members of the Council and were, as I am advised, available to members of the profession conducting those inquiries which the technical procedure manual of Deloitte, Plender & Co. contemplated. They read as follows:[2]

"*Present:* T. C. Kinnear, President, W. G. Leonard, D. L. Gordon, W. J. Ayers, L. C. Crawford, J. A. Cross, D. B. Davis, C. F. Gaviller, J. W. Glendinning, J. W. Grant, T. A. M. Hutchison, R. D. Isbister, R. J. Kane, C. L. King, G. A. MacDougall, J. A. Orr, R. E. Saunders, G. H. Spence, Arthur Stone (Wright & McTaggart, Institute Solicitors) and T. Merrilees, Registrar.

1. *Introduction:*

The President noted that this was a special meeting called pursuant to a Council resolution of November 24, 1961, for the purpose of hearing charges preferred again William L. Walton, a member, and William Wagman, a member.

2. *William L. Walton*
*William Wagman:*

Messrs. Walton and Wagman entered the meeting and identified themselves. The President explained the purpose of the meeting and Mr. Walton and Mr. Wagman individually agreed that the charges against each of them should be heard jointly. The Registrar tabled Statutory Declarations covering mailing of notices of the meeting to the members charged.

The Chairman of the Committee on Professional Conduct, W. J. Ayers, read the charges against Mr. Walton as follows:

The Council
The Institute of Chartered Accountants of Ontario
Toronto, Ontario

Dear Sirs,

The Secretary of the Institute hereby submits the following charges respecting William L. Walton, a member of the Institute, namely:

That the said William L. Walton, of the City of Toronto, in the County of York

(a) Signed or associated himself with a report, statement or representation which he knew, or should have known, was false or misleading, contrary to Rule 5 of the Rules of Professional Conduct in that as a member of the firm of Walton, Wagman &

[2] Idem—Certified copy of Report and Minutes of Special Meeting of the Council of the Institute of Chartered Accountants of Ontario, February 16, 1962.

Co., a financial statement and auditors' report of Marling Estates Limited, as of February 28th, 1961, was given which the said William L. Walton knew, or should have known, was false or misleading in several particulars.

(b) Gave in the said financial statement and auditors' report referred to in (a) above, exceptions which are sufficiently material to nullify the expression of opinion, contrary to Rule 7, sub-rule (d) of the Rules of Professional Conduct.

DATED at Toronto this 24th day of November, 1961.

Yours very truly,
(signed)
D. L. Gordon
Secretary

Mr. Ayers stated that in substance the charges against Mr. Wagman were the same as those against Mr. Walton, and Mr. Wagman agreed to dispense with formal reading of the charges against himself. For the record, the charges read as follows:

The Council
The Institute of Chartered Accountants of Ontario
Toronto, Ontario

Dear Sirs,

The Secretary of the Institute hereby submits the following charges respecting William Wagman, a member of the Institute, namely:

That the said William Wagman, of the City of Toronto, in the County of York

(a) Signed or associated himself with a report, statement or representation which he knew, or should have known, was false or misleading, contrary to Rule 5 of the Rules of Professional Conduct in that as a member of the firm of Walton, Wagman & Company, a financial statement and auditors' report of Marling Estates Limited, as of February 28th, 1961, was given which the said William Wagman knew, or should have known, was false or misleading in several particulars.

(b) Gave in the said financial statement and auditors' report referred to in (a) above, exceptions which are sufficiently material to nullify the expression of opinion, contrary to Rule 7, sub-rule (d) of the Rules of Professional Conduct.

DATED at Toronto this 24th day of November, 1961.

Yours very truly,
(signed)
D. L. Gordon
Secretary

Messrs. Walton and Wagman were asked whether they acknowledged the correctness of the charges against them and each replied, 'Yes'.

Mr. Ayers then laid before the meeting evidence relating to the charges and Messrs. Walton and Wagman presented their explanations.

Messrs. Walton and Wagman then withdrew.

3. *Punishment:*

A member of Council questioned whether the two members charged realized what was involved in their having acknowledged the correctness of the charges, this being the equivalent of a plea of guilty. Mr. Walton and Mr. Wagman were therefore invited to return to the meeting and the President explained that the procedure in formal hearings was not to request a plea of guilty or not guilty but to ask whether the person charged acknowledged the correctness of the charges against him, this being equivalent to requesting a plea. They both stated that they understood that their acknowledgement of the correctness of the charges was, in effect, a plea of guilty. They then withdrew.

It was resolved that William L. Walton and William Wagman, having pleaded guilty to the charges laid against them, they should be reprimanded. (T. A. M. Hutchison/R. J. Kane)

It was further resolved that the charges and the results of the hearing should be publicized to the membership without disclosure of the names of the members concerned. (W. G. Leonard/G. A. MacDougall)

(*Note*: T. C. Kinnear, D. L. Gordon and W. J. Ayers refrained from voting on each motion.)

Mr. Walton and Mr. Wagman re-entered and were advised of the punishment ordered by the Council, following their acknowledgement of the correctness of the charges against them. They were reprimanded by the President and then withdrew from the meeting."

Had inquiries been made, as they should have been, and this information supplied, it is inconceivable that the auditors of Atlantic Acceptance beginning a new and important engagement would not have applied additional tests, including examination of the working papers, to the work of Wagman, Fruitman & Lando on the accounts of subsidiary companies using, at the end of the 1964 fiscal year, assets of over $40,000,000, or approximately one-third of the consolidated assets of Atlantic Acceptance Corporation.

In fairness to Mr. Duncan and other members of Deloitte, Plender, Haskins & Sells, three things must be made clear. In the first place, he was not asked, either by Mr. Shepherd or myself, a direct question as to whether the firm of Wagman, Fruitman & Lando were known to him or to his partners and associates. From his evidence, read as a whole, I infer that they were not; indeed if they had been it is difficult to believe that their work would have been implicitly relied upon. In the second place, Duncan testified that Clement L. King was the senior partner of Deloitte, Plender & Co. at the material time, with administrative responsibilities covering the whole of Canada and with no direct connection

with the Atlantic audit, and I accept his evidence. King was killed on July 5, 1965, when a passenger in a Canadian Pacific Airlines aircraft which exploded in mid-air en route from Vancouver, B.C. to Whitehorse in the Yukon Territory, under circumstances which strongly suggested sabotage but which did not in my opinion, in spite of speculation at the time, suggest that he was the selected victim and that his connection with the auditors of Atlantic Acceptance was the reason. As a result of this unhappy and premature conclusion of a distinguished career he was not available to give information to this Commission. Thirdly, it is not suggested that Deloitte, Plender & Co. did, or omitted to do anything in the course of the Atlantic audit which should not, or should have been done according to the rules of conduct of their profession as constituted at the time. After Atlantic Acceptance had defaulted, and after the full implications of what had happened became known to the public mainly as a result of this Commission's proceedings, these rules were changed, as will be seen, and it may be said that the Atlantic failure was as much of a watershed in the history of accounting in Canada, and perhaps abroad, as was that of McKesson & Robbins Inc. in the United States, on which the Securities and Exchange Commission reported in 1939. The most that can be said is that, if they had observed the provisions of their own technical procedure manual more closely, they might have uncovered sufficient irregularities in the auditing of the accounts of the Adelaide Street group of subsidiaries and of Premier Finance Corporation as well, as will be seen hereafter, to cause them to qualify heavily their opinion on the consolidated statements and perhaps to decline to express one at all. Such results would have taken more time than the actual audit did, and would undoubtedly have provided a warning to discerning members of the public earlier than June, 1965; the borrowing power of Atlantic Acceptance would have been earlier curtailed, and perhaps extinguished, but it is difficult to estimate what the advantage to the public might have been had the difficulties of Atlantic Acceptance become known some three months before the default of June 14 which, in the way of disclosure, was as sudden and as mortal as a thunderbolt.

Duncan also testified that after the collapse of Atlantic Acceptance Alan Christie had expressed to him surprise that Deloitte Plender & Co. had not been engaged to perform the audit of all the subsidiary companies, as well as that of the Oakville group, and Christie's evidence is to the same effect. The artlessness of this observation is a measure of the inattention to Atlantic business of the president of Great Northern Capital Corporation and his Wall Street partners to whom the Atlantic financial statements had been available for four months. But C. P. Morgan himself must have been well aware of his personal danger when a large firm of independent auditors appeared on the scene at the instigation of Atlantic's parent company. The suggested form of the auditors'

report, specifying the percentage of total assets held by subsidiary companies not audited by Deloitte Plender & Co., which appeared harmless to Duncan, could scarcely have failed to give additional arguments to those Atlantic directors, who had secured their appointment, for having them in subsequent years conduct the audit for all the Atlantic companies, a development which Morgan was bound to resist in the foreseeable future or submit to ruin and disgrace. His refusal to entertain any change in the form of the opinion substantially similar to that given by Wright, Erickson, Lee & Macdonald in previous years, and in accordance with the prevailing Canadian practice, can be understood in the light of his own precise knowledge of what was amiss. Duncan's acceptance of the stand taken by management in this matter was perhaps unfortunate in the light of his knowledge of the size of the assets in the hands of subsidiary companies audited by other chartered accountants, but it was in my view consistent with practice acceptable at the time, and indeed still acceptable in that management is still apt to insist that new procedure, material to the expression of an auditor's opinion on financial statements, should not be introduced. By the same standards an independent auditor would not at the time have considered it proper to insist upon such novelties when he was otherwise able to express an unqualified opinion upon the financial statements of a client. At a later stage I will allude to the evidence given by members of a committee appointed by the Institute of Chartered Accountants of Ontario to present its view to the Commission on certain aspects of accounting and auditing.[3] The submissions of members of this committee[4] are Appendix L and may there be read in full, but for the moment it is perhaps sufficient to quote that of Mr. J. G. Arthur, F.C.A., chairman of this committee and partner in the firm of Peat, Marwick, Mitchell & Co., dealing with generally accepted accounting principles and auditing standards and procedures relating to business enterprises organized for profit, other than banks, trust companies and insurance companies.[5] Concerning an auditor's duties and rights in connection with the preparation of his report he wrote:

> "If he has reservations as to, or if he disagrees with, the form or content of the financial statement he cannot change it. He can only state in his report the extent of his reservations or disagreement. The financial statement is clearly that of the company and is not that of the auditor and the prime responsibility for the statement rests with the directors. An auditor may, as part of his review of the system of internal check and control, offer suggestions to management for improvement. In addition, an auditor because of his special knowledge of a client's affairs and his wide experience in other fields may render useful service to his client in such fields as taxation and management consulting. However,

[3] Evidence Volume 93.
[4] Exhibits 3647-51.
[5] Exhibit 3647.

it is not part of the auditor's duty to state whether a business is badly or well run.

If an auditor has occasion to qualify his report, it usually represents a fairly serious step and the shareholders should not take a qualification lightly. In practice, qualifications are relatively uncommon because in most cases, as the result of prior discussion between management and the auditor, the matter, which otherwise might have been the subject of a qualification, has been dealt with to the satisfaction of the auditor."

Mr. Arthur's evidence was given to the Commission on December 21, 1966.

## Responsibility of Wright, Erickson, Lee & Macdonald

In Chapter II, dealing with the early days of Atlantic Acceptance Corporation, I have already referred[1] in an introductory way to C. P. Morgan's approach to the determination of the allowance for bad debts, an attitude which boded ill for the future. Both from the evidence of David Davidson,[2] for long secretary-treasurer of the company, and Barrie L. McFadden,[3] his assistant and subsequently treasurer, it is clear that Morgan considered these allowances as adjustable to the profit situation and did not scruple to reduce them to a level at which a profit, mounting year by year, could be maintained. For those who are not familiar with accounting practice it should be stated that the preparation of financial statements and the provision of allowances and reserves is the function and responsibility of a company's management. The function of the auditor can be best understood if it is first noted that the French translation of the word "audit" is "vérification". The word "audit" is defined in the Canadian Institute of Chartered Accountants' "Terminology for Accountants" as:

"1. An examination of books of account and supporting evidence to determine the reliability of the information recorded.

2. In connection with financial statements, an examination intended to lead to the expression of an opinion as to whether financial statements of an enterprise present fairly its position as at a given date and the results of its operations for the period ended on that date in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

In many cases accountants will in fact prepare financial statements from a company's books where management has not the knowledge or facilities for preparing its own, but essentially the auditing function is one of examining, testing and expressing an opinion. Consequently, and in practice, the determination of a proper allowance for bad debts is a

[1]p. 41.
[2]Evidence Volume 79.
[3]Evidence Volume 89.

matter of negotiation from time to time between the client's management and its auditors when the latter feel that the allowance is inadequate, at least to the point where, unless an acceptable reservation is provided, they must qualify their opinion of the fairness of the statements in relation to this particular item. As already observed in Chapter II, Davidson testified that there was an annual difference of opinion between Morgan and Wright, Erickson, Lee & Co. Mr. James E. Lee, C.A., the partner in the Wright firm who supervised the Atlantic audit, gave evidence at some length on his recollection of the firm's relationship with Morgan, and said that although they were engaged to audit Atlantic Finance Corporation, the first of the subsidiaries of Atlantic Acceptance, their failure to secure the audit of Commodore Sales Acceptance caused the members of the firm to wonder why they were not appointed as auditors for this and other subsidiaries as they were created or acquired; "but ethics had prevented us from asking". His firm did not follow the practice of examining the working papers of the auditors of the subsidiaries, and his description of the relationship with Walton, Wagman & Co. is instructive.[4]

> "Q. Let us take first the firm of Walton and Wagman. In the course of consolidation, what contact would you have from year to year with members of that firm?
>
> A. Of course, we would review their statement with their report and see to it that the inter-company accounts reconciled and any point that was the least bit obscure to us from their statement, we would contact them either by telephone or by mail and get it cleared up.
>
> Q. What type of point would be obscure or might have been obscure?
>
> A. It is difficult to remember, but on occasion the presentation of the sum of the subsidiary's balance sheet was such as to merge accounts together which we required broken down to be sure the inter-office accounts balanced. This would be one example.
>
> Q. When you did have occasion to be in contact with the Walton, Wagman firm, with whom would you speak ?
>
> A. To the best of my knowledge, the only member of that firm with whom we were in contact was Mr. Fruitman.
>
> Q. Did you personally know Mr. Walton?
>
> A. No.
>
> Q. Did you know Mr. Wagman?
>
> A. No, I didn't know Mr. Wagman. I was introduced to him once, but just long enough—I saw him just long enough to be introduced."

Mr. Lee went on to say that Morgan was generally co-operative in the period when he had dealings with him about the audit, but in later

[4]Evidence Volume 79, pp. 10730-1.

years it became difficult to arrange an appointment with him for discussions that were considered essential. He gave a useful description of the auditors' approach to the allowance for bad debts for the companies which they examined.[5]

> "Q. What practice did you follow in determining what was the appropriate allowance for losses?
>
> A. We reviewed the accounts and, as you know, in this type of business there is a multitude of small accounts which have to be taken in groups pretty well according to age and repayment performance. With small accounts, our approach was to apply the percentage to each of these groups depending on the degree of uncollectability we would assume was present from their age and general performance.
>
> Q. Let us define small accounts. Approximately what are we speaking of?
>
> A. The ordinary dealer's retail paper would be unusual, I think, to have an account of more than $5,000, in that category, and those of that amount would be comparatively few.
>
> Q. Would it be fair to say then that speaking generally, when you are talking about small accounts, you are talking about some such standing of less than $5,000?
>
> A. Yes.
>
> Q. I take it the first thing you see is the age of those accounts to see whether or not there is any delinquency and if there is, how long it has existed. Is that correct?
>
> A. Yes. I might add in the finance business, there is more than just age. There are what is known as 'C.S.B.'s', which is an abbreviation for "collateral sold balance". These are situations where the article on which the lien is held has been repossessed and sold. There is still money owing. This is about the worst type of balance that could still be on the books. This is the bottom of the ladder. From there on up there are varying degrees of—
>
> Q. Do you look at each account and first place it in a category and then age it? Is that it?
>
> A. Yes, although the operation is virtually one and the same because collateral sold balance is normally an old account.
>
> Q. Did you follow the practice of applying percentages which you thought would be appropriate reserve against each of these classifications?
>
> A. Yes.
>
> Q. How did you determine the appropriate percentage?
>
> A. Very arbitrarily, really. For example, we probably would require 90 per cent reserve on the collateral sold balance, assuming there would be a 10 per cent hope of retrieving a portion of the account.

[5]Evidence Volume 79, pp. 10732-6.

Q. Do you determine the percentage appropriate to be reserved in consultation with the company's officers?

A. The company usually had a reserve already set up for allowance. We independently reach our own conclusion as to what we thought was the appropriate allowance. This became a topic for discussion at the annual review of the draft financial statement.

Q. Are you able to state whether in general, with this company, the allowance you thought appropriate, at least prior to discussion, was usually higher or lower or the same as reserve which the company had seen fit to set up?

A. We were invariably higher.

Q. So much for small loans. I will return in a moment to deal with them all at once. What practice did you follow in determining the appropriate allowance in respect of large loans?

A. In respect of large accounts, we examined each one individually having regard to the age, then the amount of security held and so on, and applied the allowance to each of these individual balances or none at all, as the case required.

Q. Do I understand then that in respect of larger accounts, you did not apply simply a percentage arbitrarily determined, but rather you made a judgment in respect of each of its accounts?

A. Yes. In the final analysis, the judgment was expressed in the form of a percentage allowance on that account.

Q. In respect of larger accounts, was the amount you deemed appropriate to set up as allowance for uncollectibility prior to discussion with the company usually larger, smaller or the same as the allowance which internally the company had set up?

A. Usually larger.

Q. Then we come to the point where you have finished your work and since your idea of the appropriate allowance on small accounts is almost invariably larger, I think you said, and on the larger accounts is usually larger, you must have had in mind a reserve significantly higher than that which the company had at first thought appropriate?

A. Yes, we were always higher.

Q. How do you resolve that?

A. Well, if the company—of course, when I say 'the company', this is Mr. Morgan brings forward its case for a lower allowance than what we had. Sometimes it involves the introduction of evidence that we hadn't had before. In those instances, we consider that evidence. If we consider this was sufficient to warrant a reduction in our previously estimated allowance, we reduced it. If we were not satisfied, we didn't.

Q. Are you able to state whether the ultimate figure which appeared in the balance sheet was or was not usually higher than that which the company had seen fit to allow?

A. To the best of my recollection, we usually finished with a higher figure than what the company started with.

Q. Did Mr. Morgan personally interest himself in these discussions and in these calculations?

A. Yes."

The Commission's accountants examined the audit working paper files of Wright, Erickson & Co. in August 1967, with a view to determining the principal differences of opinion between the auditors and management as to proper allowance for bad debts and the adjustments finally agreed upon for the fiscal years 1961, 1962 and 1963. These were tabulated:

| | *Total Amount of Accounts Receivable Under Review* | *Original Opinion of Auditors* | *Original Opinion of Management* | *Differences Between Original Opinions* | *Adjustment Finally Agreed Upon* |
|---|---|---|---|---|---|
| *December 31, 1961* | | | | | |
| Reference: | | | | | |
| Exhibit 3550........ | 18,597,035 | | | | |
| Industrial Div. Exhibit 3548 (Page 3F)........ | | 75,000 | Nil | | |
| General Accts. Exhibit 3550 (Page 3-20)....... | | 512,173 | 393,202 | | |
| TOTALS.......... | $18,597,035 | $587,173 | $393,202 | $193,971 | Nil |
| *December 31, 1962* | | | | | |
| References: | | | | | |
| Exhibit 3559........ | 26,411,721 | | 430,058 | | |
| Industrial File Exhibit 3554 (Page 3F)........ | | 61,000 | | | |
| Exhibit 3559 (Page 3-68)....... | | 647,416 | | | |
| TOTALS........... | $26,411,721 | $708,416 | $430,058 | $278,358 | $55,000 |
| *December 31, 1963* | | | | | |
| References: | | | | | |
| Exhibit 3561........ | $34,999,486 | | | | |
| Exhibit 3561 (Page 3-30)....... | | $784,088 | $700,088 | $ 84,000 | $84,000 |

It will be noted that only in 1963 did the auditors have their way without compromise and it must always be borne in mind that they were only conducting the audit for the Oakville companies.

Lee described with professional restraint the circumstances under which his firm were advised of the loss of what, at the time, must have been one of their largest engagements. He was told of the change by Morgan on the telephone in June 1964. No reason was assigned except the opinion of Atlantic's board of directors that a "national firm" should be employed because of the expansion of the company into provinces

other than Ontario. It was not until October, when he received the "courtesy letter" from Deloitte, Plender & Co., that he knew the identity of his firm's successors who sent a representative to the offices of Wright, Erickson & Co. to review their files and working papers. This example of co-operation and the furnishing of information was, no doubt, a matter of course as between chartered accountants under similar circumstances, and one could wish that the same custom had prevailed in relation to the auditors of subsidiary companies, and a similar visit made to inspect the records and working papers of Wagman, Fruitman & Lando and E. M. Sprackman, Siderson & Co. But obviously, from the evidence, the reputation and capacity of these firms were as little known to Wright, Erickson & Co., throughout the period of their engagement as auditors of Atlantic Acceptance, as they were to Deloitte, Plender & Co., and this fact, which was of crucial and far-reaching importance, must be accepted as one of the oddities of professional conduct which can be explained, if not justified, as a rigid observance of the rules of the game. It is noteworthy that the "scope paragraph" for the audit, as reported year by year by Wright, Erickson & Co., contained a reference to the number of subsidiary companies not included in their examination, and in this respect was more informative than that of Deloitte, Plender & Co. for 1964. For the year ended December 31, 1963 it read as follows:[6]

> "We have examined the consolidated balance sheet of Atlantic Acceptance Corporation Limited and subsidiary companies as at December 31, 1963 and the consolidated statements of income and retained earnings for the year ended on that date. In respect of Atlantic Acceptance Corporation Limited and two of the subsidiary companies our examination included a general review of the accounting procedures and such tests of accounting records and other supporting evidence as we considered necessary in the circumstances. In respect of the remaining seven subsidiary companies we were furnished with balance sheets as at December 31, 1963 and statements of income and retained earnings for the year ended on that date with the respective auditors' reports thereon."

The witness declined the invitation of counsel to justify the inclusion of these cautionary words, and his views generally on the subject may be stated with advantage.[7]

> "Q. Did you give any consideration at any time to the wisdom or otherwise of indicating in your certificate the percentage of assets included in the subsidiary companies which you did not audit?
>
> A. No.

[6]Exhibit 44.
[7]Evidence Volume 79, pp. 10747-9.

Q. Do you have an opinion whether there was any well understood practice in Canada at that time respecting the desirability of including such an observation?

A. So far as I am aware, such an observation was not and currently is not required by Canadian practice.

Q. What about the practice of identifying the subsidiaries by name? You put them in by number and at least state the number of the subsidiaries. Do you give any consideration to the advisability of naming the subsidiary?

A. No.

Q. And is your answer the same to the question whether there was a practice respecting that?

A. Yes. My answer to that would be the same.

Q. And do you make the same answer to the question whether or not one ought to have at that time identified the auditors?

A. Yes, the answer would be the same.

Q. Looking back at your earlier certificates, Mr. Lee, and without going through them one by one, I observe that in each case you appear always to specify at least the number of subsidiaries which were audited by you and the number of subsidiaries which were not audited by you. Is that correct?

A. I could not state that as a fact without looking at the statement, but you showed me three or four before the hearing.

Q. For the year 1958, looking at Exhibit 39, I observe that there was no qualification or reference to subsidiaries of any kind in your certificate. No doubt that would be a year in which you were auditing all the subsidiaries, or all that have any material assets. Is that correct?

A. Correct.

Q. And then in 1959 for the year ending 31st December, 1959, you make reference to four subsidiaries?

A. That is right.

Q. Thereafter in each year you appear always to refer to the number of subsidiaries which you are not auditing?

A. Yes, that is correct. That would be 1959 to 1963.

Q. What is the purpose of giving the number of subsidiaries that you don't audit?

A. I don't think we had any particular purpose. It was just a form of phraseology that we adopted for this particular situation."

He testified further that during his discussion with the representatives of Deloitte, Plender & Co. the practice of stating the number of the subsidiary companies not audited by Wright, Erickson & Co. was not the subject of comment.

## The Commission's Hypothesis

When it became apparent at an early stage that the accounting treatment of the allowance for bad debts, with respect to loans made by companies in the Atlantic complex, was vital to a proper understanding of the reasons for the collapse in June 1965, it was decided that Mr. J. A. Orr, F.C.A., the Commissioner's financial and auditing adviser, should undertake an examination of the books and records of Atlantic Acceptance Corporation and all of its subsidiary companies for the year ended December 31, 1964, and again for the previous fiscal year ended December 31, 1963, with a view to determining what the consolidated financial statements of Atlantic Acceptance should have disclosed at those dates had they been examined by a competent and independent auditor, receiving all the information required to enable him to express an unqualified opinion in accordance with generally accepted accounting principles. Mr. Orr gave evidence to the Commission on the results of his considerable task on October 27 and 28, 1966[1] and submitted two reports described as "Analysis of Accounts Receivable and Bad Debt Allowance Requirements", the first as at December 31, 1964,[2] and the second as at December 31, 1963.[3] The importance of this analysis is such that the two reports are reproduced in full as Appendices H and J. The task was a difficult one for an accountant to perform, because it involved the major hypothesis that he would have been engaged to conduct the audit for the parent company and all its subsidiaries and that he would receive full and frank answers to all his inquiries. It was also necessary for him to exclude knowledge acquired after the event of default, except in so far as it could legitimately be drawn upon as equivalent to what full and frank disclosure would have amounted to; here again it must be emphasized that if an auditor has reason to believe that this is not forthcoming he should decline to express an unqualified opinion and, in cases where the good faith, as opposed to the knowledge of the principals of a company is lacking, he should decline to express an opinion of any kind. In introducing this evidence Mr. Shepherd elicited the information that the witness's firm, Touche, Ross, Bailey & Smart, had been auditors for several years of one of the Canadian chartered banks, one of the major trust companies, and certain acceptance finance and leasing companies carrying on substantial business, and in the course of his service with them he had personally performed work on these audits in various degrees of seniority. Since all of the Atlantic companies, with the exception of the insignificant Concourse Agencies, were engaged in the business of lending money their assets largely consisted of the right to collect money lent. Thus the auditors' first concern was to verify the existence of the asset, or the

[1]Evidence Volumes 76-7.
[2]Exhibit 3477.
[3]Exhibit 3478.

right to collect, and then to value it by determining its collectibility; in short the auditor must satisfy himself as to the adequacy of the allowance for bad debts.

Accountants are accustomed to say that accounting is an art rather than a science, and the definition of "generally accepted accounting principles" is in consequence difficult because of the large variety of accounting situations arising from the consideration of the special problems of different types of institutions. The accounts of banks, trust companies, railway companies and municipalities, to name only a few, have over the years been approached in different ways, and different accounting practices in relation to them derived from experience, from the conclusions of the governing bodies in the profession, and in some cases from judicial decisions. As in other professions, the fledgling accountant is trained by his instructors, and by the practitioners who employ him, to do things in a manner which is generally acceptable to members of the profession and consistent with the standards of service generally given to the public. Consistency in practice and in the observance of ethical standards is a prime consideration of the governing bodies of the profession, and its maintenance in Canada is assisted by the publication of bulletins from time to time by the Canadian Institute of Chartered Accountants which co-ordinates the work of accounting and auditing research for all of them. The student of accounting, and of course the practitioner himself, are familiar with the works of the leading authorities on auditing, and these play as important a part in achieving consistency in accounting and auditing practice as they do in analogous aspects of the legal and medical professions. In addition, the practice of public accountancy is ordered in Ontario by the Public Accountancy Act, R.S.O. 1960 c.317 which, as amended in 1962, defines "public accountant" as follows:

"(d) 'public accountant' means a person who either alone or in partnership engages for reward in public practice involving,

(i) The performance of services which include causing to be prepared, signed, delivered or issued any financial, accounting or related statement, or

(ii) the issue of any written opinion, report or certificate concerning any such statement,

where by reason of the circumstances or of the signature, stationery or wording employed, it is indicated that such person or partnership acts or purports to act in relation to such statement, opinion, report or certificate as an independent accountant or auditor or as a person or partnership having or purporting to have expert knowledge in accounting or auditing matters, but does not include a person who engages only in bookkeeping or cost accounting or in the installation of bookkeeping, business or cost systems or who performs accounting or auditing functions exclusively in respect of,

(iii) any public authority or any commission, committee or emanation thereof, including a Crown company,

(iv) any bank, loan or trust company,

(v) any transportation company incorporated by Act of the Parliament of Canada, or

(vi) any other publicly-owned or publicly-controlled public utility organization;"

The Act provides for a Public Accountancy Council for Ontario of fifteen members, twelve of whom must be appointed by the Council of the Institute of Chartered Accountants of Ontario, described as the "qualifying body", and three elected by persons licensed under the Act who are not members of the Institute. To put it shortly, the statutory council has the function of licensing all public accountants in the province, who may or may not be members of the Institute and entitled to the style "Chartered Accountant", but who have completed the course of study prescribed and administered by it. Formerly the Certified Public Accountants of Ontario were also a "qualifying body", but all became members of the Institute of Chartered Accountants in 1962; and, although section 15 of the Act contemplates the licensing of those existing members and students of the Certified General Accountants Association of Ontario and of other public accountants who had practised as such in Ontario under licence at the time of the amalgamation of the C.A.'s and C.P.A.'s in 1962, the effect of the amendments of that year was to recognize only members of the Institute as qualified for licensing in the future. Mr. Orr, at the time he gave his evidence, had been a member of the Council of the Institute and was one of its representatives on the Public Accountancy Council of Ontario. This should be borne in mind when reading the following extract from his evidence which served to introduce his description of the auditing procedures which he would have expected to have seen applied in considering the required allowances for bad debts by auditors of Atlantic Acceptance and its subsidiary companies in 1963 and 1964:[4]

> "Q. Then would a competent and independent auditor who has been given full information necessarily arrive at the same result with respect to the allowance for doubtful accounts as would all other like auditors in the same circumstances?
>
> A. Not on an exact basis, because it is perhaps not an exact science, but I think that they would have reached the same result within a narrow bracket. They would have been using the same fundamental principles, and it is there because you have an element of opinion and judgment, and that could vary from auditor to auditor, from individual to individual as well.

[4]Evidence Volume 76, pp. 10230-3.

Q. You say there is an element then of opinion to be dealt with. Can you enlarge on that?

A. If I would be allowed to I would quote from the Bulletin No. 4 which I referred to earlier, of the Canadian Institute of Chartered Accountants.

Q. Are you going to read a passage from it?

A. I would like to.

Q. Then perhaps you would read it fairly slowly.

A. This is quoting from page 2 of this bulletin, and I am going to commence at the paragraph numbered 4 'Determination of Reserve Required'. By the way, this bulletin was published in 1950. The word 'Reserve' is not in normal usage today, but the word 'Allowance' is, and you will find we are using these two expressions.

> 'The estimated reserve required is a matter of opinion and the actual loss eventually sustained may be more or less than the estimate. The variation will depend not only on the pessimism or optimism of the estimator but also on events which have yet to occur and which cannot be foretold, such as future collection policies of the enterprise and future business conditions. The impossibility of making an exact forecast does not, however, relieve the management of the responsibility of making a careful estimate of the reserve required.
>
> No formula can be set out which, by itself, provides a means by which the amount of reserve can be determined. The nature of the particular business, the class of customers, the frequency and value of individual sales, the collection policy, the efficiency of the collection department and general business conditions at the time are all factors which must be taken into account.'

Q. Then are you saying this, Mr. Orr, that by reason of universal and accepted practices among accountants, derived in part from the literature to which you have referred, and perhaps in greater part from oral instruction, and to their experience, all accountants charged with the responsibility of examining a statement of a company whose assets consist in the main of a right to collect money would regard it as of the highest importance to make an appropriate allowance for doubtful accounts, and they would be guided by the same well-understood principles, but that because the element of opinion must of necessity bulk large, some variance is to be expected among competent, disinterested auditors in any given situation in establishing the allowance. Is that what you are saying?

A. Yes, that is correct.

Q. Can you state in this particular instance what variance might fairly be expected among competent and independent accountants from the allowance for losses about which you are going to testify as having been estimated by you?

A. I would expect to find a variance of not exceeding 10 per cent one way or the other. There is one little area we might just bring out, sir. This is another assumption fundamental to it, that the man has done this type of an institution, of which there are not a great number, at some time in its existence, or has available to him people who can guide him in his first go at it."

The witness's belief that a competent, independent and experienced accountant's estimate of a bad debt allowance required for a finance company would not vary from that of any other by more than 10%, one way or the other, was later disputed by Messrs. Fruitman and Lando. When they testified to the Commission on November 21, 1966[5] they were represented by counsel who at that time gave notice that, when the Commission was prepared to hear additional evidence from affected persons, they would apply for leave to cross-examine Orr and to submit evidence on behalf of their clients. On May 30, 1967, at the time set for hearing additional evidence and argument, the only appearance made by anyone was by Mr. Perry Brooks of a Toronto firm of solicitors, Messrs. Pivnick, Givens & Chusid, who offered a submission in writing prepared by Fruitman and Lando which may be read at Appendix M. This submission made no attempt to deal with the circumstances of their own conduct as auditors, about which they had already testified, but amounted to a review of literature on the subject of "generally accepted accounting principles". In this they pointed out, with many illustrations from authoritative texts and the writings of leaders of the profession, that a wide variety of views as to what these principles consisted of had prevailed for many years, and that in consequence Orr's conclusion was fallacious. In point of fact Orr dealt in this evidence with standards of auditing rather than principles of accounting, and the Fruitman-Lando submission is not particularly apposite. The views of these two young men, of whose participation in the audits of Commodore Sales Acceptance, Commodore Factors, Adelaide Acceptance and Aurora Leasing Corporation their professional brethren have taken a serious view, must be returned to again.

**Evidence of John A. Orr**

A summary of Mr. Orr's lengthy evidence must now be attempted. He described the steps which he would have expected auditors to take in the combined audit of Atlantic Acceptance and all of its subsidiary companies. A senior member of the firm would undertake

(a) a discussion with senior company officials to clarify the obligations of the company in preparing the financial statements and the obligations of the auditor in rendering an opinion upon them;

[5]Evidence Volume 83.

(b) a discussion to determine, first, if it were the company's policy to engage in lending money at high or low risk and second, the existence of a company manual of procedures for examining requests for loans, setting limits for approval of loans by specific officers, describing financial information required from prospective borrowers and existing debtors for determining the worth of collateral to be taken, setting out procedures for the collection or writing off of delinquent accounts and prescribing a consistent method of analysing overdue accounts in terms of "age" or, in other words, the length of time which each account is overdue;

(c) analysis of the system of internal control set out in the company's manual for procedure to ensure that the work of one employee provides a check on the work of another, or in other words to ensure that no one person has unlimited or unscrutinized control over major assets of the company;

(d) as a result of establishing the existence and operation of procedures referred to in (b) and (c) a determination of the amount of checking and confirmation required in the audit programme.

The next step would be, under the direction of a partner, to develop the audit programme in detail and to carry out the audit in accordance with it.

The witness then went on to relate the foregoing procedures to what the senior member would have found as a result of his preliminary inquiries at Atlantic Acceptance Corporation. At the head office in Oakville there would have been available and produced for his examination explicit policies and procedures in writing, providing for internal control, lending, collection, write-offs and the lending limits prescribed for individual officers. These had been subjected to extensive auditing tests both at the head office and at the branch offices of Atlantic Acceptance Corporation and Atlantic Finance Corporation. After a detailed review of auditing procedures and the information available to Wright, Erickson, Lee & Macdonald for the operations of these companies in 1963, and to Deloitte, Plender, Haskins & Sells in 1964, Mr. Orr concluded that his opinion as to the fairness of the allowances for bad debts would have been the same as was reached by the auditors for those years. The same could be said for those of the two minor subsidiaries, Concourse Agencies and Pay As You Study Plan, the size of which in terms of their assets, liabilities and earnings, if any, were not material, although in the case of the latter it was to be noted that Deloitte, Plender & Co. had increased the allowance for bad debts in respect of gross accounts receivable of some $34,000 from the $3,500 reserved by Walton, Wagman & Co. for 1963 to $16,600 in 1964. Standard Discount's allowances were also considered proper for the two fiscal years considered.

A very different situation would have confronted the auditors when they turned their attention to the Adelaide Street subsidiaries of Atlantic Acceptance and to Premier Finance, armed with the authority to audit their financial statements, an authority which, it must always be borne in mind, Wright, Erickson & Co. and Deloitte, Plender & Co. did not possess in respect to the audits for 1963 and 1964 respectively. By the end of 1964 over $44,000,000 had been advanced by Atlantic Acceptance to these companies and had been re-loaned at interest to many borrowers. To assess the worth of these advances the auditors of Atlantic would have been bound to form an opinion as to the value of the loans made by these subsidiaries, and an audit similar in scope to that undertaken for the Oakville companies and Standard Discount would have been required. It would have been apparent at the outset from conversations with A. G. Woolfrey, as director of operations for Commodore Sales Acceptance, that there was no consultation about the granting of loans with any form of "loan committee", that C. P. Morgan alone gave or withheld approval for all the loans made and did so without the benefit of any "loan file" worthy of the name. A loan file should include, at the very least, a debtor's current financial statement, and, if he were in the business of lending money, a list of accounts receivable, credit reports and internal memoranda on the subject of his credit rating, and generally such information as to his background as would satisfy the auditor that his client had made an effective analysis of the risk before making a loan to him. Nothing systematic of this kind was maintained for Commodore Sales Acceptance, Commodore Factors and Adelaide Acceptance and, although there were files containing correspondence with debtors and solicitors and a few files of Chartered Management Consultants kept in the offices of Wagman, Fruitman & Lando, no auditor would have considered that these records provided adequate documentation for the huge amounts of money which these companies had at risk.

The auditors' next step would have been to secure trial balances of the accounts receivable at various dates during the fiscal year under examination, and perhaps during the year immediately preceding it, to get the "feel" of the company's operations and ascertain the distribution of the risk among borrowers, the borrowers of the largest loans and their history of repayment. Here it would have caused them great concern to find that loans were heavily concentrated among a small group of debtors, that several of these were in excess of a million dollars and were continuously increasing in size. Once they had confirmed the existence of these loans as stated, the problem of determining their collectibility would have led to much more extensive and pertinent inquiries than would be necessary in the case of the more widely distributed loans of smaller size made by the Oakville companies and Standard Discount.

An examination of such files as existed at 100 Adelaide Street would have revealed disquieting circumstances. For example the Commodore Sales Acceptance file of its loans to D.H.I. Limited included a report, signed "H. Cooper per H.W.", not dated, but which from all the surrounding evidence appeared to have been prepared in 1961. The writer of this report, apparently signed on his behalf by Harry Wagman, was evidently that H. K. Cooper, formerly principal shareholder of Crest Acceptance Corporation Limited, who testified to the Commission that he did per diem work for Chartered Management Consultants at the request of W. L. Walton during 1961 and up until the end of March in 1962.[1] An extract from the last page of the report itself[2] should be quoted, since it would have come to the attention of the auditors early in their examinations of the larger loans and would have had a predictable effect upon their view of the lending operations of Commodore Sales Acceptance.

> "The first fact to be faced is that D.H.I. is insolvent. Thus the criterion for factoring is the customers' paper itself. If the future paper submitted is with the same class of customers as the first assignment, this will definitely be favourable to the dealings with D.H.I. On the other hand, if D.H.I. cannot make enough profit to pay the factoring charges and at the same time provide working capital for itself and its fixed obligations, then it will not last too long as an active business. What position will Commodore be in if it is necessary to collect on its security most of which is in the form of progress Draws? Is the 15% interest charges worth the hazards involved? Factoring is a difficult enough business when dealing with a solvent Co., in my opinion, the profit involved with D.H.I. does not merit the risks."

After reading this the auditors would have seen that at December 31, 1961, a date approximately contemporaneous with that of Cooper's report, D.H.I. owed Commodore Sales Acceptance only $65,000, but that at December 31, 1962 the debt had risen to approximately $685,700, at the same date in 1963 to $2,351,000, and at the end of 1964 to $3,968,000. If any assurances had been given about the prospects of D.H.I. after the Cooper report had been seen, the auditors would have found another document headed "D.H.I. Limited May 14, 1964," with the initialled signature "F. K. Cockburn" appended, reading in part[3]:

> "The aged list of Accounts Receivable provided by D.H.I. as at April 30, 1964, has been examined and compared to the detail at March 31, 1964. These receivables are increasing month by month at an unhealthy rate.
>
> Collections during April amount to approximately $253,000 and the

[1]Evidence Volume 8.
[2]Exhibit 3471.
[3]Exhibit 3472.

> net increase for the same period amounts to approximately $190,000. Advances correspondingly total $443,000.
>
> We must take immediate steps to collect some of the larger delinquent accounts and we were promised sufficient detail to make this practical. This information has not yet come to hand and we again requested it today."

Then again, the file of Commodore Factors on the loans to General Spray Service Inc. included a financial statement of that company as at June 30, 1963[4] showing working capital in a deficit position and operating losses. Attached to this statement was an unusual document entitled "Miscellaneous Observations", unsigned and evidently derived from one of the "field audits" made for Commodore Factors by the personnel of Chartered Management Consultants, which commented severely on the inefficiency of the management of General Spray, the payment of commissions before the proceeeds of sales had been received and the inadequacy of the book-keeping conducted by Donald Lear. By December 31, 1964 $1,304,000 had been advanced by Commodore Factors to this company.

The anxiety caused by these discoveries would have rapidly mounted when it was borne in upon the auditors that out of a total loan portfolio of nearly $30,000,000 at December 31, 1964 Commodore Sales Acceptance had advanced no less than $8,825,000 to Aurora Leasing Corporation and $7,335,000 to Dalite Corporation.[5] The overwhelming size of these loans would require a close examination of the business transacted by each company, the use that was being made by each of the money lent and its financial position generally. At this point very little doubt would remain in their minds that they were not dealing with normal loan and factoring business, and an immediate approach to C. P. Morgan would be indicated for production of detailed information about the principal debtors. In the case of Aurora Leasing Corporation an examination of its trial balance of loans,[6] with a view to assessment of their individual collectibility, would have revealed that Aurora also, with its ostensible business as a leasing company which was carried on to a limited extent, was in the business of lending money, with six loans amounting to over $7,000,000 out of total accounts receivable of $14,250,000. In the case of the loan of $2,100,000 owed to Aurora by Evermac Office Equipment Company Limited there would have been a dearth of information outside the Aurora ledgers, since at October 28, 1966, when Mr. Orr's evidence was given, even the notes as evidence of the debt were missing. Moreover the auditors would have found the following strange communication in the files of both Commodore Sales Acceptance and Aurora:[7]

[4]Exhibit 2324.
[5]Exhibit 578.
[6]Exhibit 587.
[7]Exhibit 3473.

"16th December, 1964.

Aurora Leasing Corporation Ltd.,
111 Richmond Street West,
Toronto, Ontario.
Attention: Mr. W. E. Pahn.

Dear Sirs:

In accordance with the terms of notes given in respect of your indebtedness to Commodore, we wish to make certain specific assignments operative, as follows:

Cimcony of Canada Limited
Evermac Office Equipment Company Limited
Associated Canadian Holdings Limited
Freeport International Company
Mortgage Trust and Savings

The said assignments are to be operative immediately and we would further direct that the accounts of reference shall be collected by you and thereafter remitted to Commodore.

We agree that the said accounts shall not be notified in order not to disturb the continuity and request that you acknowledge the above by signing and returning one copy of this letter.

Yours very truly,
COMMODORE SALES ACCEPTANCE LIMITED,

A. G. WOOLFREY,
Treasurer.

Acknowledged and agreed to.
'W. E. Pahn'
AURORA LEASING CORP. LTD."

The amounts represented by these "specific assignments", net of accrued interest, may be seen in the following tabulation:

| | |
|---|---|
| Cimcony of Canada Limited | $ 537,663.75 |
| Evermac Office Equipment Company Limited | 2,075,027.55 |
| Associated Canadian Holdings Limited | 1,005,000.00 |
| Freeport International Company | 1,540,000.00 |
| Mortgage Trust & Savings | 250,000.00 |
| | $5,407,691.30 |

Commodore Sales Acceptance had, or believed it had, a general assignment of Aurora's book debts as security for its advances dating from December 21, 1960 and when Mr. Orr testified he was unable to suggest an explanation of this step taken by Woolfrey and, without doubt, at C. P. Morgan's direction. The financial statement prepared for Aurora

by Wagman, Fruitman & Lando and dated March 9, 1965, which one must assume, for the purpose of the general hypothesis, would have been supplied in some form, would have shown that this transaction had the effect of reducing the reported liabilities of Aurora by the total amount of these loans which were referred to in a note to the balance sheet in that statement as "re-discounted notes" for which the company was contingently liable.[8] Nothing complementary appeared in the books of Commodore Sales Acceptance, and the patent nonsense of this treatment would have at once been apparent to the auditors who would then, if not before, have been aware of the kind and quality of the accounting services performed by Wagman, Fruitman & Lando. Further reference to the Aurora financial statements as at December 31, 1964 must be made, because *two* sets were prepared and reported on by that firm and this led to difficulties for its members. In any event the adjustment which reduced Aurora's notes payable from $12,200,209 to $7,426,394, entered on December 31, 1964, was promptly reversed on January 1, 1965, and can only have been made for the purpose of improving the appearance of the year-end statement.

The inordinate size of the amount receivable by Commodore Sales Acceptance from Aurora Leasing would have compelled the auditors to require the most detailed information bearing on the collectibility of the latter company's loans. Many of its debtors would have been found to be borrowers also from the Adelaide Street companies, and D.H.I. Limited, which owed Aurora $739,600, was an example. Had detailed information about the borrowers from Aurora not been forthcoming, the auditors would have been unable to express an unqualified opinion on the balance sheet of Commodore Sales Acceptance or, in the alternative, might have insisted on a heavy allowance for bad debts of some 90% to 100% against the Aurora account alone. The nature of C. P. Morgan's dilemma can now be discerned, even in the early stages of an independent audit of the Adelaide Street subsidiaries by auditors charged with the duty of expressing an opinion on the consolidated financial statements of Atlantic Acceptance. The company needed an unqualified opinion to avoid investigation by the Toronto Stock Exchange, and to comply with the provisions of the various trust indentures securing the notes by which it sustained its large public borrowings; it would thus be expected to produce, at all costs, the information required. Should it be withheld and the auditors forced to resign, the difficulty would not be resolved, since new auditors, in conformity with the ethics of the profession, would be compelled to inquire of their predecessors if there were any professional reasons why a new appointment should not be accepted; the fact that required information had been refused, or was not forthcoming, would ensure the refusal to express an opinion, and perhaps a refusal to assume the new engagement at all.

[8] Exhibit 294.

The list of irregularities among the subsidaries which would have come to the attention of auditors of the parent company would, at this point, be by no means exhausted. The practice of capitalizing unpaid interest by issuing a new note for the unpaid amount, so often remarked in preceding chapters of this report, and the transfer, as in the case of the Groship companies, of large delinquent accounts to new companies under new notes would also have caused concern. An examination of promissory notes, debentures, agreements and correspondence would have disclosed the fact that many of the debtor companies had officers in common, and that some of these, such as Harry Wagman, Walter Pahn and J. C. Laidlaw, had a significant relationship with C. P. Morgan himself. The verification of collateral security for many of the loan accounts would have disclosed that it either did not exist or was hopelessly inadequate; in more than one case, and particularly in that of D.H.I., the security was not given to the lender itself but to A. G. Woolfrey in trust.[9] In general, although policies for the safeguarding of assets in force at Oakville would have been regarded as normal, they would have been found at 100 Adelaide Street West to be virtually non-existent, and interest rates of anywhere from 11% to 15% per annum on inventory and operating loans exacted by the subsidiary companies, compared with those of 7% to 8% generally prevailing at the time, would have caused further disquiet. Finally the auditors would be struck by the fact that their predecessors in the audit of the Adelaide Street subsidiaries were Walton, Wagman & Co. who, with their successors Wagman, Fruitman & Lando, had performed the same function for a large number of the debtor companies, representing 31% of all the borrowers from Commodore Sales Acceptance, Commodore Factors and Adelaide Acceptance owing 68% of their loans receivable, and 29% of borrowers from Aurora Leasing Corporation owing 41% of loans receivable by that company. The detail of this calculation is as follows:[10]

| | *Total Accounts* | | *Amounts which were clients of Walton, Wagman & Co. and/or successor firm* | | *Percentage of total accounts which were clients of Walton, Wagman & Co. and/or successor firm* | |
|---|---|---|---|---|---|---|
| | *Number* | *$ Value* | *Number* | *$ Value* | *Number* | *$ Value* |
| Commodore Sales Acceptance Limited...... | 55 | $29,931,289 | 23 | $23,675,647 | 42% | 79% |
| Commodore Factors Limited................ | 16 | 7,031,381 | 1 | 1,119,142 | 6% | 16% |
| Adelaide Acceptance Limited................ | 18 | 4,018,027 | 4 | 3,231,509 | 22% | 80% |
| | 89 | $40,980,697 | 28 | $28,026,298 | 31% | 68% |
| Aurora Leasing Corporation Limited..... | 42 | $14,252,594 | 12 | $ 5,791,034 | 29% | 41% |

[9]Exhibit 3474.
[10]Exhibit 3476.

### Required Allowance for Bad Debts

From what would have been revealed thus far it was Mr. Orr's view that the auditors would have required up to date financial information about all the debtor companies, and it is clear from the memoranda submitted by members of the special committee of the Institute of Chartered Accountants of Ontario[1] that his estimate of the required allowance for bad debts represents the prevailing opinion of the accounting profession in Ontario at the time. If the auditors of the consolidated financial statements of Atlantic Acceptance Corporation had conducted the audit of all the subsidiary companies of Atlantic Acceptance, as well as that of the parent company, they would not have accepted information over a year old without setting up substantial allowances to offset uncertainty as to the current situation. Assuming that the information needed was available, they would have proceeded to establish separate allowances for each of the large accounts receivable on the assumption that both creditor and debtor were going concerns. Mr. Orr said that the reports of the analysis of the accounts receivable and the required allowances for bad debts for Commodore Sales Acceptance, Commodore Factors, Adelaide Acceptance, Premier Finance Corporation and, as a necessary and supplementary study, Aurora Leasing Corporation for the year ended December 31, 1964 and for the previous year ended December 31, 1963, prepared by him and his staff, contained the reservations which he would have considered necessary before expressing an opinion on the financial statements of the first four companies as at those dates. A closer examination of this work must now be made.

It is desirable to repeat that these reports were based on the assumption that all the known current information would have been available to the auditors, for in its absence higher allowances would have had to be made to compensate for uncertainty; in the case of the debtors actually audited by Walton, Wagman & Co. and Wagman, Fruitman & Lando this, as has been seen, would have required a considerable exercise of the auditors' art. The mechanics of the actual operation can be condensed in itemized form as follows:

1. The lists of accounts receivable for each company were examined.

2. All the information which would then have been available to an auditor was assembled for each debtor.

3. Where existing information was inadequate for the expression of an opinion, that subsequently acquired was used in order to avoid setting an excessive allowance, and on the assumption that it would have been produced in the normal course.

[1]Appendix L.

4. Generally accepted auditing methods were then applied to determine the proper allowance for each account, and the details of review in each case were set out on schedules showing
   (a) the amount of the loan outstanding,
   (b) the particulars of the latest audit or accounting report,
   (c) the salient features of the latest financial statements, showing assets, liabilities, the book value of net tangible assets and the latest annual earnings or loss,
   (d) a brief explanation of the reasons for setting the allowance at the amount shown on the schedule.
5. The amount of each debt, and the estimated allowance required in each case, were summarized to show the total allowance required for all of the companies, and to compare it with that actually reserved by the auditors of record; particular pains were taken to set an allowance in each case which, in case of doubt, was not overstated or unduly unfavourable to the lending companies; a schedule was prepared in summary form to show the effect of the required allowances on the shareholders' equity of Atlantic Acceptance Corporation for the fiscal years ended December 31, 1964 and 1963.
6. Finally, the individual schedules calculating the required allowance for each debt and the combined schedules referred to in paragraph 5 were bound together and offered in evidence as separate reports at December 31, 1964[2] and at December 31, 1963,[3] referred to as Appendices H and J to this report.

As a result of this detailed analysis a required allowance for bad debts in respect of loans made by Atlantic Acceptance Corporation and all its subsidiary companies was arrived at in the amount of $21,256,370. The constituents of this sum, in comparison with the amounts actually reserved, are shown below.

ATLANTIC ACCEPTANCE CORPORATION LIMITED
AND SUBSIDIARY COMPANIES

Analysis of Accounts Receivable and Bad Debt Allowance Requirements
as at December 31, 1964

| | *Accounts Receivable (Net of "Holdbacks" and Unearned Interest)* | *Estimated Requirement for Allowance for Bad Debts* | *Allowance Provided in the Financial Statements* | *Additional Allowance Required* |
|---|---|---|---|---|
| Commodore Sales Acceptance Limited.................. | $ 29,931,289 | $10,486,300 | $ 678,534 | $ 9,807,766 |
| Commodore Factors Limited (Converted from U.S. funds) | 7,031,381 | 4,110,000 | 172,756 | 3,937,244 |
| Adelaide Acceptance Limited. | 4,018,027 | 3,294,000 | 87,646 | 3,206,354 |
| | $ 40,980,697 | $17,890,300 | $ 938,936 | $16,951,364 |

[2]Exhibit 3477.
[3]Exhibit 3478.

| | Accounts Receivable (Net of "Holdbacks" and Unearned Interest) | Estimated Requirement for Allowance for Bad Debts | Allowance Provided in the Financial Statements | Additional Allowance Required |
|---|---|---|---|---|
| Atlantic Acceptance Corporation Limited...... | $ 47,271,151 | $ 1,197,897 | $1,197,897 | — |
| Atlantic Finance Corporation Limited.................. | 27,392,743 | 353,530 | 353,530 | — |
| Atlantic Acceptance (Toronto) Limited.................. | 304,737 | 12,000 | 12,000 | — |
| Premier Finance Corporation Limited.................. | 4,406,572 | 1,675,000 | 93,308 | 1,581,692 |
| Standard Discount Corporation Limited...... | 3,016,956 | 111,024 | 111,024 | — |
| Pay As You Study Plan Limited.................. | 27,360 | 16,619 | 16,619 | — |
| | $123,400,216 | $21,256,370 | $2,723,314 | $18,533,056 |

It will be seen that, in the opinion of this Commission's financial and auditing adviser, the allowance for bad debts reflected in the consolidated financial statements for Atlantic Acceptance at December 31, 1964 was understated by $18,533,056, and that all of this understatement occurred in the accounts of the Adelaide Street subsidiaries ($16,951,364) and of Premier Finance Corporation ($1,581,692). Its effect on the equity of the Atlantic shareholders was as stated below[4].

ATLANTIC ACCEPTANCE CORPORATION LIMITED
AND SUBSIDIARY COMPANIES

Effect on Shareholders' Equity of Provision of Appropriate Allowance for Doubtful Accounts as at December 31, 1964

| | | |
|---|---|---|
| Shareholders' equity as per published financial statements: | | |
| Capital stock........................................ | $14,455,087 | |
| Retained earnings.................................... | 1,451,076 | |
| | | $15,906,163 |
| Deduct: | | |
| Estimated requirement for allowance for doubtful accounts........................................ | $21,256,370 | |
| Less allowance provided as per published financial statements.................................... | 2,723,314 | |
| Additional allowance required.................................... | | $18,533,056 |
| | | ($2,626,893) |
| Add: | | |
| Adjustment of income tax provisions—Current year.... | $ 803,258 | |
| —Previous year.... | $ 341,270 | $ 1,144,528 |
| Shareholders' equity after correction for provision of appropriate allowance for doubtful accounts and adjustment of income tax provisions for current and previous year (impairment)........................................ | | ($ 1,482,365) |

This impairment of $1,482,365 should be compared with the surplus position of shareholders' equity actually reported by Atlantic Acceptance and its subsidiary companies of $15,906,163.[5] The effect on the consolidated net income of the group would have been to show a loss of

[4]Appendix H.
[5]Exhibit 45.

$16,629,794, instead of a profit after taxes of $1,100,004, and the calculation was illustrated thus:[6]

ATLANTIC ACCEPTANCE CORPORATION LIMITED
AND SUBSIDIARY COMPANIES

Effect on Consolidated Net Income of Appropriate Allowance for Doubtful Accounts as at December 31, 1964

| | | |
|---|---|---|
| Consolidated net income as per published financial statements............ | | $ 1,100,004 |
| Deduct: | | |
| Estimated requirement for allowance for doubtful accounts | $21,256,370 | |
| Less allowance provided as per published financial statements.......................................... | 2,723,314 | |
| Additional allowance required.......................................... | | $18,533,056 |
| | | ($17,433,052) |
| Add: | | |
| Reversal of current year's provision for income taxes................ | | $ 803,258 |
| Consolidated net income for the year ended December 31, 1964 after correction for provision of appropriate allowance for doubtful accounts and adjustment of provision for current year's income taxes (loss)............................................ | | ($16,629,794) |

NOTE:

The above schedule does not reflect any adjustments which would have been necessary in the circumstances with respect to previous years' income tax provisions.

The same presentation of the required allowance for bad debts as compared with the amounts actually reserved is also shown below for December 31, 1963.[7]

ATLANTIC ACCEPTANCE CORPORATION LIMITED
AND SUBSIDIARY COMPANIES

Analysis of Accounts Receivable and Bad Debt Allowance Requirements as at December 31, 1963

| | *Accounts Receivable (Net of "Holdbacks" and Unearned Interest)* | *Estimated Requirement for Allowance for Bad Debts* | *Allowance Provided in the Financial Statements* | *Additional Allowance Required* |
|---|---|---|---|---|
| Commodore Sales Acceptance Limited.................... | $15,373,624 | $ 4,634,000 | $ 342,713 | $4,291,287 |
| Commodore Factors Limited (Converted from U.S. funds).. | 6,097,741 | 1,844,000 | 178,303 | 1,665,697 |
| Adelaide Acceptance Limited... | 5,247,056 | 2,159,000 | 40,343 | 2,118,657 |
| | $26,718,421 | $ 8,637,000 | $ 561,359 | $8,075,641 |
| Atlantic Acceptance Corporation Limited........ | 32,666,857 | 784,088 | 784,088 | — |
| Atlantic Finance Corporation Limited.................... | 13,689,481 | 173,594 | 173,594 | — |
| Atlantic Acceptance Corporation (Toronto) Limited.......... | 147,801 | 6,000 | 6,000 | — |
| Premier Finance Corporation Limited.................... | 7,986,500 | 700,000 | 103,260 | 596,740 |
| Standard Discount Corporation Limited.................... | 2,709,702 | 115,385 | 115,385 | — |
| Pay As You Study Plan Limited. | 28,907 | 3,490 | 3,490 | — |
| | $83,947,669 | $10,419,557 | $1,747,176 | $8,672,381 |

[6] Appendix H.
[7] Appendix J.

The understatement of the allowance for bad debts for all the companies amounts to $8,672,381, and the estimated requirement of $10,419,557 is considerably less, in proportion to total accounts receivable of $83,947,669, than that of the estimated requirement at the end of the following year of $21,256,370 in respect of total accounts receivable of $123,400,216, but the size of the understatement is still very striking. Its effect on the shareholders' equity at December 31, 1963 was shown as follows.[8]

ATLANTIC ACCEPTANCE CORPORATION LIMITED
AND SUBSIDIARY COMPANIES

Effect on Shareholders' Equity of Provision of Appropriate Allowance for Doubtful Accounts as at December 31, 1963

| | | |
|---|---|---|
| Shareholders' equity as per published financial statements: | | |
| Capital Stock | $ 8,485,791 | |
| Retained earnings | 1,128,813 | $9,614,604 |
| Deduct: | | |
| Estimated requirement for allowance for doubtful accounts | $10,419,557 | |
| Less allowance provided as per published financial statements | 1,747,176 | |
| Additional allowance required | | $8,672,381 |
| | | $ 942,223 |
| Add: | | |
| Adjustment of income tax provisions—Current year | $ 341,270 | |
| —Previous year | 514,618 | $ 855,888 |
| Shareholders' equity after correction for provision of appropriate allowance for doubtful accounts and adjustment of income tax provisions for current and previous year | | $ 1,798,111 |

This figure of $1,798,111 must also be compared with the reported figure of $9,614,604. Again the effect on the consolidated net income of the appropriate allowance for bad debts at December 31, 1963, if written off in that year, would have been to show a loss of $7,516,708, instead of a recorded net income of $814,403 and this also was illustrated in tabular form.[9]

ATLANTIC ACCEPTANCE CORPORATION LIMITED
AND SUBSIDIARY COMPANIES

Effect on Consolidated Net Income of Appropriate Allowance for Doubtful Accounts as at December 31, 1963

| | | |
|---|---|---|
| Consolidated net income as per published financial statements | | $ 814,403 |
| Deduct: | | |
| Estimated requirement for allowance for doubtful accounts | $10,419,557 | |
| Less allowance provided as per published financial statements | 1,747,176 | |
| Additional allowance required | | $8,672,381 |
| | | ($7,857,978) |
| Add: | | |
| Reversal of current year's provision for income taxes | | $ 341,270 |
| Consolidated net income for the year ended December 31, 1963 after correction for provision of appropriate allowance for doubtful accounts and adjustment of provision for current year's income taxes (loss) | | ($7,516,708) |

NOTE

The above schedule does not reflect any adjustments which would have been necessary in the circumstances with respect to previous years' income tax provisions.

[8]Appendix J.
[9]Appendix J.

Two significant observations will readily suggest themselves to anyone who examines Mr. Orr's conclusions: the first must be that the difference between his estimates of the required allowance for bad debts in the case of the Adelaide Street subsidiaries and Premier Finance Corporation and those actually reserved and considered to be fair by Wagman, Fruitman & Lando in the former case, and by E. M. Sprackman, Siderson & Co. in the latter, is so startling as to provoke disbelief in the existence of any audit worthy of the name for these companies in 1963 and 1964; the second is that in the case of the companies audited by Wright, Erickson, Lee & Macdonald in 1963, and Deloitte, Plender, Haskins & Sells in 1964, it was not considered that any additional allowance for bad debts was required. "Grossly inadequate" were the words used by the Professional Conduct Committee of the Institute of Chartered Accountants of Ontario in the charges preferred against Fruitman and Lando as a description of the allowances acquiesced in by them as auditors of Commodore Sales Acceptance, Commodore Factors and Adelaide Acceptance in 1964, charges which the Discipline Committee of that body considered to be sufficiently made out. Accordingly I do not propose to spend any time in attempting to reconcile the opinions of Harry Wagman, in so far as they were expressed at all, and of Martin Fruitman and Albert Lando on the one hand with those of John Orr on the other, particularly since the whole weight of professional accounting opinion in the Province of Ontario lies in the balance against the former, other than to summarize what the latter found in the course of examining the records of the Adelaide Street companies and the audit working papers of the Wagman firm, and those of Premier Finance Corporation and the audit working papers of the Sprackman firm. The working paper files of Walton, Wagman & Co. and Wagman, Fruitman & Lando showed no detailed calculation of bad debt allowance in the case of individual accounts receivable, and the allowances set up for each of the companies appeared to be in the nature of a general reserve only. The working papers contained only a trial balance of accounts receivable, with limited comment as to the security held and on adjustment of the allowance for bad debts. The recognized procedure of circularizing debtors to obtain confirmation of the extent and status of their loans had apparently not been systematically undertaken, and the files indicated that the auditors' approach to their task had been largely mechanical, with sparse and incomplete records of such tests as may have been performed. In the case of the Premier Finance Corporation there was no detailed listing or "aging" undertaken for the accounts receivable in respect of "hard goods". The financing of conditional sales contracts in this field which, according to the evidence of Donovan R. Lytle related mainly to installation of aluminum siding on houses, and involved a great many dubious transactions instigated by unscrupulous

salesmen of that material, was discontinued by the company in 1964, and collection of the receivables turned over to the careful management of Standard Discount Corporation. Lytle's evidence, which was given to the Commission on February 14, 1967, described how in 1963, under the direction of C. R. Sherrill, he investigated at least this aspect of Premier's business.[10]

"Q. Premier Finance, then, financed a class of receivables secured by what is called hard goods and a class of receivables secured by what are called soft goods?

A. That is correct.

Q. Did you, yourself, personally, go into this company to examine the nature of its operations?

A. Accompanied by one of Mr. Sherrill's operating personnel—two of Mr. Sherill's operating personnel we did a review of the hard goods section.

Q. And what did you find?

A. We were considerably disturbed with the delinquency position and rate and record of collections, with the size of the accounts and with the nature of the security.

Q. Who was in charge of Premier Finance at that time?

A. Clarence O'Neill.

Q. Who was his superior in the Atlantic complex?

A. Mr. Morgan.

Q. Did he report to Mr. Sherrill as well?

A. No.

Q. He ran an independent operation?

A. Correct.

Q. Were the records in satisfactory state when you first went into Premier to look at the loans?

A. No, they had little or no accounting controls, as I understand them. There had not been a trial balance of the receivables taken in several years. Generally speaking it was an unsatisfactory situation as far as controls were concerned.

Q. If there were inadequate controls and no trial balance how could you find out what loans were outstanding?

A. Going exclusively by the general ledger balances, which was a gross balance.

Q. Did you, then, make up a list of the loans?

A. Several months after we got into the Premier Company operation we did a trial balance of the whole operation and of the hard goods,

[10]Evidence Volume 95, pp. 12884-92.

put them onto the same procedure as was being followed by the Atlantic branch organization, which involved putting them onto the electronic data processing equipment.

Q. Why was there a delay of several months?

A. Initially it was trying to determine what our situation was and, then, there was considerable reticence on Mr. O'Neill's part to the actual taking of the trial balance; he felt it was completely unnecessary.

Q. When you did examine the loans did you come across any large loans which attracted your attention?

A. The review of the soft goods accounts principally for—looking for larger balances I came across one in the amount of some $300,000.

Q. Who was the borrower?

A. Racan Photocopier.

Q. And that was, I take it, from what you have said, a significant amount of money when related to the size of the Premier operation. Is that correct?

A. The average balance in the soft goods was something around a $70 account; this was a $300,000 account.

Q. Had you known of the existence of the account in Premier Finance before this?

A. No.

Q. What did you do when you learned of this?

A. I called Mr. Morgan, drew it to his attention—

Q. What was the conversation?

A. I drew it to his attention, discussed it with him; told him that I had obtained no satisfaction from Mr. O'Neill as to the security behind this account or what it represented. He asked that it be left with him.

Q. That is, with Mr. Morgan?

A. That is, with Mr. Morgan. And that he would review it with Mr. O'Neill; determine the adequacy of the security and obtain any other necessary documentation.

Q. Did you gain any impression as to whether Mr. Morgan knew of the existence of this loan prior to your report?

A. He knew nothing of this loan at this time.

Q. Do I take it that he was expressing concern?

A. He was very concerned.

Q. Then, what did he do so far as you are aware?

A. He called in Mr. Sprackman who was an auditor of Premier Finance, and asked him to obtain satisfactory security and assure Mr. Morgan that we were properly secured.

Q. Yes. Did you continue then to be at Premier so that you would have more knowledge of the progress of—

A. Shortly after discovering this account I returned to Oakville on other duties.

Q. Did you return to Premier later?

A. Yes.

Q. How much later?

A. A matter of four or five months later.

Q. And what progress had been made with respect to the Racan loan?

A. Out of curiosity I looked at the account to see if it had been reduced or if any improvement had been made and, rather than being reduced, I found that it had been increased to $700,000.

Q. What was the security for this amount of money?

A. I was unable to determine this.

Q. Who is in charge of the loan now so far as you were aware?

A. Again, O'Neill—I drew it to Mr. Morgan's attention, not being aware of who had made the increase. Mr. Morgan said he had made the increase and that we were well secured.

Q. When loans, certain loans, were so treated that they might be fitted into the electrical data processing equipment was Racan among them?

A. No, it was not.

Q. That was not among them?

A. Mr. Morgan determined that the soft-goods accounts should be left in charge of Mr. O'Neill, and that certain other accounts which, in my assessment, were neither soft-goods nor hard-goods, would be left with Mr. O'Neill, and Mr. Morgan would supervise them.

Q. And was Racan one of these unusual accounts?

A. Racan was one of these accounts.

Q. How many of these unusual accounts were left with Mr. O'Neill?

A. There would be approximately two dozen accounts."

O'Neill was of course the president of Premier Finance Corporation, operating a proprietary concern known as O'Neill Finance Company on the side, and was referred to as Clarence F. O'Neill in Atlantic circles and as C. Frank O'Neill in the more rarefied atmosphere of York Trust & Savings Corporation, of which he was a director as late as June 30, 1965 and the difficulties of which have not yet receded from public recollection. According to Lytle, the aluminum siding accounts were principally generated by a firm called Modern Building Products and amounted to some $4,000,000 out of approximately $6,000,000 worth of accounts receivable in the "hard goods" section.

**Allowance for Commodore Sales Acceptance Loan to Aurora Leasing**

I shall not follow Mr. Orr through the lengthy evidence which he gave about the determination of proper allowances for bad debts, particularly in the case of the largest borrowers, since the schedules contained in Appendices H and J are self-explanatory. One of them, however, must be reconsidered, not only because of its critical effect on what must be regarded as the true situation of Atlantic Acceptance Corporation at December 31, 1964, but because of contemporary events which might conceivably have altered the view of the auditors in their opinion of what that allowance should have been had their attention been directed to them. This is the calculation of the required allowance for the debt of Aurora Leasing Corporation to Commodore Sales Acceptance and for convenience it is here reproduced:

COMMODORE SALES ACCEPTANCE
AURORA LEASING CORPORATION LIMITED

| | |
|---|---|
| Balance receivable at December 31, 1964 | $ 9,456,244 |
| Less: Floating charge debenture of Dalite Corp. | 631,000 |
| Net amount receivable at December 31, 1964 | $ 8,825,244 |

LATEST FINANCIAL REPORT

Audited financial statements prepared by Wagman, Fruitman & Lando at December 31, 1964.

| | |
|---|---|
| MAJOR ASSETS | |
| Term accounts receivable | $ 1,422,768 |
| Notes receivable | 1,303,767 |
| Call notes receivable | 3,878,610 |
| Mortgages | 2,239,758 |
| Rediscounted notes receivable | 5,407,691 |
| Equipment (less depreciation $778,126) | 1,305,420 |
| Cash | 252,876 |
| MAJOR LIABILITIES | |
| Outstanding cheques | $ 993,316 |
| Notes payable—secured | 6,792,518 |
| Convertible unsecured notes payable | 529,000 |
| Due re: re-discounted notes | 5,407,691 |
| Deferred revenue | 1,357,692 |
| Shareholders' equity—net tangible assets | $ 411,545 |
| Discount of assets—allowance for bad debts required less $100,000 already provided | $ 5,353,500 |
| Discounted net tangible assets | ($ 4,941,955) |

Security held—General assignment of book debts dated December 21, 1960.

| | |
|---|---|
| MAJOR CREDITORS AT DECEMBER 31, 1964 | |
| Commodore Sales Acceptance Limited (Note 1) | $ 8,825,244 |
| British Mortgage & Trust Company | 1,700,000 |
| Adelaide Acceptance Limited (Note 2) | 2,210,883 |

NOTES

1. Commodore Sales Acceptance transferred a $631,000 receivable owing by Dalite Corporation (Canada) Limited to Aurora Leasing Corporation Limited. Aurora Leasing Corporation Limited, however, never accepted this account or recorded it on its books. Commodore Sales Acceptance Limited subsequently reversed the transaction and gave Aurora Leasing Corporation Limited a credit of $631,000. A formal legal assignment was never executed.
2. Although Adelaide Acceptance Limited notes were described as 'secured' on the Aurora Leasing Corporation Limited balance sheet, there was no evidence of any registered security.

ALLOWANCE FOR BAD DEBTS

| | | |
|---|---|---|
| Total assets per financial statements | | $15,710,890 |
| Less: Deferred revenue | | 1,357,692 |
| | | $14,353,198 |
| Less: Estimated increase in allowance for doubtful accounts | | 5,353,500 |
| Estimated realizable value of assets | | $ 8,999,698 |
| Less: Preferred creditors—Income taxes payable | $ 8,642 | |
| Outstanding cheques up to amount of cash in bank—say | 252,876 | 261,518 |
| | | $ 8,738,180 |
| Less: British Mortgage & Trust Company loan—secured by specific assignment of book debts | | $ 1,700,000 |
| Assets available to meet Commodore Sales' loan secured by a general assignment of book debts | | $ 7,038,180 |
| Commodore Sales Acceptance Limited's loan | | 8,825,244 |
| Deficiency in security | | ($ 1,787,064) |
| Allowance required, say | | $ 1,800,000 |

It will be observed that the deficiency in security for the Commodore Sales Acceptance loan of $8,825,244 was shown as $1,787,064. It was noted that the lender was secured by a general assignment of book debts and British Mortgage & Trust Company, as to a loan of $1,700,000, by a specific assignment of book debts. In the first volume of the minutes of meetings of the directors of Aurora Leasing[1] the auditors would have found, as a schedule to the record of the meeting of December 19, 1960 attended by Carl M. Solomon, Harry Wagman, William L. Walton, David M. Samuel and Betty Crisp, a photostatic copy of the general assignment of book debts by Aurora Leasing to Commodore Sales Acceptance, already referred to in Chapter XV.[2] It must be assumed that they would also have been advised of the specific security held by Carl M. Solomon in trust for British Mortgage, intended to be an assignment of accounts receivable by Aurora Leasing to him in this capacity, amounting to 125% of the amount loaned by the trust company represented from time to time by the Aurora notes which it held. Then again, since financial statements of Aurora for the year ended December 31, 1964 on which Wagman, Fruitman & Lando expressed an unqualified opinion on March 9, 1965,[3] and subsequent statements prepared for the same fiscal year on which they qualified their opinion on July 8, 1965,[4] contained, as note 2 to the former and note 1 to the latter, the cryptic comment "notes payable are secured by a general assignment of book debts", it must be assumed that the auditors would have been confronted by an assertion that all the notes payable to Commodore Sales Acceptance, British Mortgage & Trust and

[1]Exhibit 287.
[2]p. 1091—footnote.
[3]Exhibit 294.
[4]Exhibit 295.

Adelaide Acceptance were secured by competing assignments. At this point I think it highly probable that solicitors would have been consulted and their opinion sought as to the value of the security held by Commodore Sales Acceptance. The solicitors would have noted that the general assignment of book debts given by Aurora to that company on December 21, 1960 was registered in the office of the Clerk of the County Court of the County of York[5] and thus complied with the provisions of section 3 of the Assignment of Book Debts Act, but it is inconceivable that they would have failed to note that the affidavit of *bona fides* taken by Solomon described him as president of Aurora Leasing Corporation which was the assignor; and, since he was specifically described as "president of the Toronto branch of Aurora Leasing Corporation Limited", they would have realized that Solomon had clumsily adapted a printed form of assignment as supplied to their customers by a chartered bank, thus rendering the assignment invalid against other creditors of Aurora. Further inquiry would have shown that no documents could be found indicating that Adelaide Acceptance was secured at all, but an examination of the security held by British Mortgage & Trust would have revealed that what was held by Solomon as trustee for that company had diminished in value by December 31, 1964 to $163,500, represented by a note which, be it said, was not negotiable in the hands of British Mortgage & Trust. These circumstance have been discussed at length in Chapter XV, and it must again be assumed that the exiguous documentary evidence of the Solomon trusteeship as described therein[6] would have eventually been considered by the solicitors. As a result of finding Commodore Sales Acceptance, Adelaide Acceptance and British Mortgage & Trust unsecured in respect of loans made by them to Aurora Leasing, some adjustments to the required allowances for bad debts in the case of the receivables of the first two might have been considered.

The required allowance for the Commodore Sales Acceptance loan to Aurora of $1,800,000 was based on the assumption that British Mortgage & Trust Company held security which would have given it preference over Commodore Sales Acceptance, and that the latter held security which would have been good against other unsecured creditors, including Atlantic Acceptance. The Commission's accountants have made two further assumptions since Mr. Orr's evidence was given, the first being that neither Commodore Sales Acceptance nor British Mortgage & Trust were secured and that all creditors ranked equally against the assets of Aurora, and the second that British Mortgage & Trust was secured but that Commodore Sales Acceptance and Adelaide Acceptance were not. In the former case the required allowance to be made by Commodore Sales Acceptance would have been $2,770,000

[5]Exhibit 4971.
[6]pp. 1106-8.

instead of $1,800,000 and for Adelaide Acceptance $695,000 instead of $2,200,000; these allowances in the aggregate for the Adelaide Street companies would have been $3,465,000 instead of the $4,000,000 felt to be required when the evidence was given. In the latter case the allowance required for Commodore Sales Acceptance would have been $3,195,000, and for Adelaide Acceptance $800,000, or a total of $3,995,000 compared with $4,000,000. The Commission's most recent information indicates that all attempts to settle the competing claims of Victoria and Grey Trust Company, as successor to British Mortgage, Montreal Trust Company as receiver and manager of Atlantic Acceptance, and the Clarkson Company Limited as trustee of the bankrupt estate of Aurora Leasing Corporation have been unsuccessful, and litigation has begun to determine the validity of Aurora's assignment of book debts to Commodore Sales Acceptance. Whatever the result of this may be, it is irrelevant to the situation of the auditors, under the hypothesis which has been developed thus far, in establishing a prudent allowance for the bad debts of Commodore Sales Acceptance in respect of its loans to Aurora at December 31, 1964 which might, under the two assumptions considered and as a result of legal advice, have been increased from $1,800,000, as calculated in the first place, to either $2,770,000 or $3,195,000. Under any circumstances the equity of the shareholders of Atlantic Acceptance would have been heavily impaired.

**Wagman, Fruitman & Lando and the Aurora Audit**

It has been seen that Mr. Orr and his staff were of the opinion that the assets of Aurora Leasing should be discounted by $5,353,500, representing the total allowance required for its bad debts, plus the $100,000 actually reserved by the company at December 31, 1964. He provided a detailed analysis of the accounts receivable of Aurora at that date and at December 31, 1963 in support of his suggested allowances, on the same basis as those prepared for the Adelaide Street subsidiaries. Here again, the fact that a large number of Aurora's debtors were audited by Walton, Wagman & Co. or Wagman, Fruitman & Lando, who were also responsible for the Aurora audit, would have been of disquieting significance. These debtors included Cimcony of Canada Limited of which Wagman was treasurer and for which S. S. Chusid, of Wagman, Fruitman & Lando, was acting as trustee, Valley Farm and Enterprises Limited, of which Wagman was a director and officer holding a one-third interest, Frederick's Department Store Limited of which he was a shareholder, Associated Canadian Holdings of which he was a director and shareholder, Dallas Holdings Limited of which he was a director and shareholder and N.G.K. Investments Limited of which he was a shareholder; Wagman also owned 7,000 shares of Aurora Leasing Corporation itself. Some further consideration must be given to the two audited

financial statements prepared by Wagman, Fruitman & Lando for the year ended December 31, 1964, and in examining the evidence given by members of this firm on the subject it should be rememberd that Aurora's books of account were maintained by Walter E. Pahn, secretary of the company and an employee of Chartered Management Consultants, a Trio company which carried on its business in the offices of the Wagman firm.

The first statement prepared for the year ended December 31, 1964 showed the balance sheet as follows:[1]

AURORA LEASING CORPORATION LTD.

(A Company incorporated under the laws of the Province of Ontario)

BALANCE SHEET
AS AT DECEMBER 31, 1964

(With comparative figures as at December 31, 1963)

| | 1964 | | 1963 | |
|---|---|---|---|---|
| *ASSETS* | | | | |
| Cash | | $ 252,876 | | $ 43,748 |
| Receivables (pledged): | | | | |
| Term accounts | $1,422,768 | | $1,693,916 | |
| Notes | 1,303,767 | | 2,432,612 | |
| Call notes (see note #1) | 3,878,610 | | 5,208,202 | |
| Mortgages | 2,239,758 | | 129,335 | |
| | $8,844,903 | | $9,464,065 | |
| Allowance for doubtful accounts | 100,000 | $ 8,744,903 | — | $ 9,464,065 |
| Equipment (less accumulated depreciation 1964—$788,126. : 1963—$546,774.) | | 1,305,420 | | 1,348,761 |
| | | $10,303,199 | | $10,856,574 |

| | 1964 | | 1963 | |
|---|---|---|---|---|
| *LIABILITIES* | | | | |
| Outstanding cheques | $ 993,316 | | $ 68,945 | |
| Accrued liabilities | 108,117 | | 51,542 | |
| Notes payable—secured (note #2) | 6,792,518 | | 8,170,515 | |
| Unearned interest | 60,817 | | 70,439 | |
| Provision for exchange | 2,037 | | 2,037 | |
| Income taxes payable | 8,642 | $ 7,965,447 | 653 | $ 8,364,131 |
| 7% Unsecured notes payable—Due December 31, 1965 —Convertible into common shares at $3.00 each | $ 559,000 | | $ 600,000 | |
| Converted during the year | 30,000 | 529,000 | 41,000 | 559,000 |
| Total Liabilities | | $ 8,494,447 | | $ 8,923,131 |
| *Deferred Credits:* | | | | |
| Deferred revenue | | 1,357,692 | | 1,590,303 |
| Accumulated tax reductions applicable to future years (note #4) | | 39,515 | | — |
| Total Liabilities and Deferred Credits | | $ 9,891,654 | | $10,513,434 |

[1]Exhibit 294.

*SHAREHOLDERS' EQUITY*

| | 1964 | | 1963 | |
|---|---|---|---|---|
| *Capital Stock:* | | | | |
| Authorized: 1,000,000 Issued: (note #3) 123,670 Common shares without par value not to exceed $400,000 | $ 276,010 | | $ 246,015 | |
| *Retained Earnings:* | | | | |
| (As per statement) | 135,535 | | 97,125 | |
| Total Shareholder's Equity | | 411,545 | | 343,140 |
| | | $10,303,199 | | $10,856,574 |

APPROVED ON BEHALF OF THE BOARD:

(Signed) J. C. Laidlaw Director

(Signed) W. E. Pahn Director

To be read with the attached Auditors' Report and notes dated March 9, 1965.

In the statement of operations an allowance for doubtful accounts of $100,000 was shown under expenditures and the net profit for 1964 as $73,590. The first two notes to these statements were as follows:[2]

NOTE NO. 1: The company is contingently liable in respect of re-discounted notes to the extent of $5,407,691.

NOTE NO. 2: Notes payable are secured by a general assignment of book debts.

Effect was here given to Woolfrey's letter on behalf of Commodore Sales Acceptance to Aurora Leasing of December 16, 1964 by removing from the assets and liabilities of the latter the sum of $5,407,691 and setting up a contingent liability in respect of "re-discounted notes", a transaction which, as already noted, was not reflected in the accounts of Commodore Sales Acceptance and which was immediately reversed in those of Aurora Leasing. Attached to these statements was the auditors' report, addressed to the shareholders of Aurora Leasing Corporation Limited in the following terms:

"We have examined the balance Sheet of Aurora Leasing Corporation Ltd. as at December 31, 1964, and the Statements of Operations and Retained Earnings for the year ended on that date. Our examination included a general review of the accounting procedures and such tests of the accounting records and other supporting evidence as we considered necessary in the circumstances.

In our opinion the accompanying Balance Sheet and Statements of Operations and Retained Earnings present fairly the financial position of the company as at December 31, 1964, and the results of its operations for the year then ended, in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Respectfully submitted,
'Wagman, Fruitman & Lando'
WAGMAN, FRUITMAN & LANDO,
CHARTERED ACCOUNTANTS."

Toronto, Ontario.
March 9, 1965.

[2]Exhibit 294.

The second set of statements[3] also contained a balance sheet at December 31, 1964 with comparative figures for 1963.

AURORA LEASING CORPORATION LTD.
(A COMPANY INCORPORATED UNDER THE LAWS OF THE DOMINION OF CANADA)
BALANCE SHEET
(WITH COMPARATIVE FIGURES FOR THE YEAR ENDED DECEMBER 31, 1963)
*(Cents Omitted)*

| | *1964* | | *1963* | |
|---|---|---|---|---|
| ***ASSETS*** | | | | |
| Cash | | $ 252,876 | | $ 43,748 |
| *Receivables (Pledged)* | | | | |
| Term accounts | $1,422,768 | | $1,693,916 | |
| Notes | 1,303,767 | | 2,432,612 | |
| Call notes | 9,286,301 | | 5,208,202 | |
| Mortgages | 2,239,758 | 14,252,594 | 129,335 | 9,464,065 |
| Equipment (less accumulated depreciation—1964—$778,126; 1963—$546,774) | | 1,305,420 | | 1,348,761 |
| | | 15,810,890 | | 10,856,574 |

| | *1964* | | *1963* | |
|---|---|---|---|---|
| ***LIABILITIES*** | | | | |
| Outstanding cheques | $ 993,316 | | $ 68,945 | |
| Accrued liabilities | 108,117 | | 51,542 | |
| Notes payable—secured (note 1) | 12,200,209 | | 8,170,515 | |
| Unearned interest | 60,817 | | 70,439 | |
| Provision for exchange | 2,037 | | 2,037 | |
| Income taxes payable | 8,642 | $13,373,138 | 653 | $ 8,364,131 |
| 7% unsecured notes payable—due December 31, 1965—convertible into common shares at $3.00 each | 559,000 | | 600,000 | |
| Converted during the year | 30,000 | 529,000 | 41,000 | 559,000 |
| Total liabilities | | 13,902,138 | | 8,923,131 |
| *Deferred Credits:* | | | | |
| Deferred revenue | | 1,357,692 | | 1,590,303 |
| Accumulated tax reductions applicable to future years (note 2) | | 39,515 | | |
| | | 15,299,345 | | 10,513,434 |
| ***SHAREHOLDERS' EQUITY*** | | | | |
| *Capital Stock:* | | | | |
| Authorized: 1,000,000 Issued: (note 3) 123,670 common shares without par value | 276,010 | | 246,015 | |
| Retained earnings (as per statement) | 235,535 | | 97,125 | |
| Total shareholders' equity | | 511,545 | | 343,140 |
| | | 15,810,890 | | 10,856,574 |

APPROVED ON BEHALF OF THE BOARD:

_______________ Director

_______________ Director

The accompanying Auditors' Report and notes form an integral part of these financial statements.

[3] Exhibit 295.

By reason of the fact that no allowance was made for doubtful accounts, the net profit was stated as $173,590 and the note about the contingent liability in respect of re-discounted notes was omitted. The second statement was attached to a covering letter dated July 8, 1965, addressed to Aurora Leasing Corporation Limited, directed to the attention of Mr. J. C. Laidlaw, and signed for Wagman, Fruitman & Lando by "A. M. Lando", referring to Lando's attendance at a special meeting of directors of Aurora on June 25 for the purpose of,

"(a) discussing preliminary draft statements for the company for the year ended December 31, 1964 and

(b) obtaining instructions with respect to the finalization of the statement to shareholders and in particular the accounts receivable."

This letter concluded by referring to Laidlaw's request on July 6 "for our audited financial statements", and by drawing his attention "to our qualification in the Auditors' Report". This report read as follows:

> "We have examined the Balance Sheet of Aurora Leasing Corporation Ltd. as at December 31, 1964, and the Statements of Operations and Retained Earnings for the year ended on that date. Our examination included a general review of the accounting procedures and such tests of the accounting records and other supporting evidence as we considered necessary in the circumstances.
>
> We have examined particulars of security held in support of receivables, where applicable, and are not satisfied as to the adequacy of the security given by the customers, nor have we received satisfactory instructions from management with respect to an adequate allowance for doubtful accounts.
>
> Since the Balance Sheet date, the company's largest creditor has exercised its rights pursuant to a general assignment of book debts and the accounts are now under the control of the said creditor. We have received no report from the creditor as to the condition or collectibility of the accounts.
>
> Because of the materiality of the items set forth in the preceding paragraphs we are unable to express an opinion on the overall fairness of the financial statements except to indicate that they have been prepared in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.
>
> Respectfully submitted,
>
> 'Wagman, Fruitman & Lando'
>
> Toronto, Ontario,
> July 8, 1965.
>
> WAGMAN, FRUITMAN & LANDO
> CHARTERED ACCOUNTANTS."

It is not disputed that the signature "Wagman, Fruitman & Lando" to the auditors' report in both cases is in the handwriting of A. M. Lando.

Harry Wagman, as the senior partner of the firm, was questioned by Mr. Shepherd about these unusual circumstances.[4]

"Q. Who was responsible for the audit of Aurora Leasing Corporation?
A. I don't know just who did the work on the Aurora audit, but I believe that Mr. Lando did the finalizing of the statement.

Q. Would that include the work which the auditor performs relative to the establishment of the allowance for losses?
A. It would be part of it.

Q. With whom did Mr. Lando, according to your recollection, have his discussions about the adequacy of the allowance for losses in the case of Aurora?
A. To my recollection I don't believe there was a discussion held. That is why the statement was not properly completed. I believe at the time he sent out a statement which was supposed to have been discussed.

Q. Do you say that in the case of Aurora there was a statement sent out which was not yet complete?
A. It was not yet complete insofar as having the discussion with the directors before finalizing it.

Q. Perhaps you could assist me on something that puzzles me. Here is Exhibit 294, a financial statement for the year ending 31st December, 1964, with a certificate from Wagman, Fruitman and Lando bearing date the 9th of March, 1964, and relating to Aurora Leasing Corporation Limited. Who appears to have signed the name 'Wagman, Fruitman and Lando' on that?
A. I think it is Mr. Lando. I would think it is. It looks like his writing.

Q. Now your last answer puzzles me, Mr. Wagman. Perhaps you could help me on this. This Exhibit 294 contains an auditors' report which appears to be in the standard form and wholly unqualified, does it not?
A. Yes, sir.

Q. Then you said there was another statement prepared, and I show you Exhibit 295, which is also a financial statement of Aurora Leasing Corporation as at 31st December, 1964. The auditors' report bears date, the 8th of July, 1965. Who appears to have signed the name 'Wagman, Fruitman and Lando' to that?
A. Mr. Lando."

Counsel then read the qualified report on the second statement dated July 8, 1965, and asked the witness for an explanation as to why there should be a financial statement for Aurora issued as at December 31, 1964, containing an unqualified report made in March, and another

[4]Evidence Volume 83, pp. 11174-5.

for the same period made in July, containing very material qualifications.[5]

"A. Well, the only thing that I could say on this matter is that this auditor's report should never have gone on here. It was done in error. It was supposed to have gone to the directors of the company.

Q. Which one is that, please?

A. That is one dated March 9, 1965.

Q. Yes.

A. This was primarily prepared for the directors of the company to have their meeting and go over this here thing and decide upon the adequacy of the reserves or any other matters they wanted to discuss and the finalization was supposed to be done after that. How this got on there is a puzzle to us, to me anyway.

Q. To what extent were you personally concerned with the preparation of the statement for which the report of the 9th of March is annexed?

A. I didn't prepare the statement."

After being invited to examine the working papers,[6] Wagman eventually concluded that the greater part of them were prepared by Walter Pahn and that the balance sheet itself was in the handwriting of Lando. He maintained that the first statement was only a draft, prepared for discussion with the directors of Aurora Leasing, which was sent to the offices of C. P. Morgan who, of course, was neither a director nor officer of the company. Lando's evidence on the subject was prefaced by questions and answers clarifying his view of the respective responsibilities of client and auditor in setting the allowance for bad debts.[7]

"Q. You were making a point a few moments ago to the effect that it is management that sets the reserve. Would you expand on that, please?

A. Well, just as accounting has a management function, a matter like this in particular would be a management function, since it requires management knowledge, management ability, our job being to assess the adequacy of management's judgment to the best of our ability, of course, in the circumstances.

Q. Then when ultimately a statement is issued with an auditor's report unqualified, is it the fact that this means that the auditor is satisfied that the allowance for loss is adequate?

A. Unless he qualifies, he is satisfied as to the fairness of the statement.

Q. Then what is it takes place between the time when management first sets what it deems to be a proper reserve, and the time at which the auditor puts his signature to the statement? Are there discussions and the like?

[5]Evidence Volume 83, pp. 11178-9.
[6]Exhibit 703.
[7]Evidence Volume 83, pp. 11225-6.

A. There are discussions throughout the piece, some of which assist management from information we bring to their attention, and others of which assist us in our assessment from explanations we receive from management, the result of which could lead to a statement which fairly presents the position of the company.

Q. What does the allowance for loss mean? Does it mean that in the opinion of the auditor, exercising the best judgment he can, if the company at the date of the statement were to realize upon its security, that it would get the net amount shown on the statement?

A. No, sir.

Q. What does it mean?

A. It is an amount set by management in order to cover any normal losses incurred in the ordinary course of business, using the going-concern concept.

Q. That is, the debtors will continue to be a going concern?

A. That is correct.

Q. It does not matter whether the lender is a going concern or not, of course?

A. This might have some bearing, yes, it might have some bearing. I would have to think about that, because it is not a concept.

Q. Then is it an attempt to evaluate the amount of money which the lending company can reasonably expect to collect over the term during which the moneys all become payable?

A. Generally that is what it is."

This witness was then asked to consider the two sets of financial statements for Aurora Leasing for the year ended December 31, 1964.[8]

"Q. I show you these two exhibits, 294 and 295, Mr. Lando. Could you assist the Commissioner as to how Exhibit 294 came into existence? This is the statement at 31 December, 1964, which includes an unqualified auditors' report.

A. The statement bearing the report dated March 9, 1965, was submitted as a draft for consideration by the directors, and was subject to additional information to be supplied by them.

Q. It contains, does it not, an unqualified certificate or report of the auditors which Mr. Wagman said bore your signature; is that correct?

A. It contains this auditors' report, and it does appear to be my signature, yes.

Q. How did you come to issue an auditors' report on it in March, 1965 if it was intended only to be a draft statement and subject to obtaining further information?

[8]Evidence Volume 83, pp. 11227-9.

A. This was prepared at the time in the form in which it was intended to take, on the assumption that I would receive all the information I required, and it was specifically directed to management that this is not for the shareholders subject to completion of my examinations. There were matters that yet had to be discussed with management.

Q. Let me see if I understand that. Do you say that it was prepared in final form, or what appeared on the surface to be final form, and that the certificate was signed, but that the directors were informed that it was not yet to be regarded as capable of being released because you required other information?

A. Yes, that is correct, sir.

Q. Why would you sign it if further information were yet required which might change the picture?

A. I had no reason at the time to expect that I would not be able to obtain the explanations I had requested, and I would have to say that signing it was an error on my part."

If this was an error, it was a substantial one and could hardly have been made by inadvertence. The statement of March 9, 1965 was a finished product, with the names of the directors signing for the board appearing on the balance sheet above the lines designated for signature and not below them, as might have been the case had it in fact been a draft. All was prepared, in short, as it might be expected to go to the printer; but Mr. Lando should, in fairness, be heard at length on the subject, particularly in connection with the "re-discounted notes".[9]

"Q. Dealing with Exhibit 294, which is the unqualified report, what was the further information which you required?

A. The first item I wanted was the opinions of the directors as to the treatment of certain accounts which show here as a note to the financial statement, re discounted notes. The company had made its assignment of book debts which it held—pardon me, that is Commodore Sales had had an assignment of book debts from Aurora.

Q. Yes.

A. Some time prior to the preparation of this financial statement it had made its assignment operative by notifying the Aurora customers that the accounts should be paid directly to them on notice.

Q. Yes. This was prior to the end of December, 1964?

A. I said so, yes.

Q. Yes.

A. The treatment of this item on the balance sheet requires some thought and consideration, since now, if the Aurora customer owes the money to Commodore Sales, should it then appear on Aurora's books as

[9]Evidence Volume 83, pp. 11229-33.

a receivable or should you contra it and treat it as a contingent liability, as I have so done here, as I say again, as a matter of suggested treatment.

Q. Yes.

A. I wanted their opinion on this, as to whether this was the method that they would like to use to treat this matter. This was one of the items.

Q. Yes.

A. Also I wished some explanations with respect to some of the long-term accounts. I had already reviewed the leases and chattel mortgage accounts and they appeared to be in rather good order, but some of what I think they called term notes, did not have a great deal of movement. I am not sure if it is 'call notes' or 'term notes'—the reference was to call notes.

Q. Yes.

A. The files were devoid of certain information that I felt I required, as a result, I believe, partly of the seizure made by the Department of National Revenue against Mr. Walton in December of 1963.

Q. Yes.

A. Many of the documents of Aurora Leasing were in these same premises, and they were taken to the Commission, to the Special Investigation Division. Some had been returned, some I understood were transcribed and just duplicated, and I did not have sufficient information in the files as they existed at the time I was doing the work, to satisfy myself.

Q. Yes.

A. I needed explanations and so on. This was another matter. There may have been other things, I do not recall exactly right now, but those two do stick out in my mind.

Q. Now in fact, while this copy put in as Exhibit 294 contains the type-written signatures, in fact it appears that Mr. Laidlaw and Mr. Pahn did approve this statement on behalf of the board; is not that so?

A. No, I do not think so. I believe those were the two who had signed it the previous year. If I could see my working papers, I believe I marked the working papers for the draft and standard report and so on. It just follows through.

Q. Do you say that it was Wagman, Fruitman and Lando which typed on the statement the signatures J. C. Laidlaw and Mr. Pahn? Is that correct?

A. Yes, I believe it was expected that they would sign it, and that is the way it usually is done, or was done by us.

Q. What do you require to see in the Aurora working papers Exhibit 703, which would assist you on that? It would be on the balance sheet, would it not, the handwritten balance sheet?

A. I seem to have part of the balance sheet and that is all.

Q. There is not anything that assists you that you can readily lay your hand on; is that correct?

A. Yes, I see I have marked here some things, right in my working papers: 'Review reserve with management before finalizing. Require list of securities held re notes. Funds turning slowly in 1964. Check operative assignments re $5,407,691 with Institute.'

Q. The last reference to $5,407,000 is the note to which you referred on your balance sheet, where the notes had been rediscounted. Is that correct?

A. Yes. This was a reminder to myself to call the Institute Consultants Committee as to what their suggested treatment for this matter would be.

Q. And did you do that?

A. I don't think I ever—I think this file was taken away from us before we got it finished. This is the solicitor's telephone number, and that is my marking 'Hold'.

Q. You say the file was taken away from you. Do you refer to the events after the 17th of June?

A. That is correct."

Lando was asked whether the circumstances described in his qualified report of July 8, in which he expressed dissatisfaction as to the adequacy of security given by borrowers and the lack of instructions from management with respect to the adequate allowance for bad debts, prevailed in March when the first statement was prepared and sent over to Morgan's office for discussion. He denied this, and said that the second statement and report were submitted after he had attended a directors' meeting of, as he recalled, Carl Solomon, J. C. Laidlaw, Wilfrid Gregory, Solomon G. Steinhart and Walter Pahn, at which he was told that the directors present knew nothing about the operational side of the company's business or about its accounts. The minute book of Aurora Leasing for this period[10] contains a notice, dated June 23, calling the meeting for June 25, signed by Carl Solomon as director and vice-president and C. G. King as director, but no minutes of the proceedings. Gregory was not a director of the company, although he and British Mortgage & Trust held over a third of its stock but, whether or not he did attend, Carman King was there, and gave a lively description to the Commission of what led up to it and what transpired. After reviewing the facts about the two statements, as they were known in December 1966 when King gave his testimony, counsel asked for the witness's recollection.[11]

"A. Well, the custom had been—they had the two companies that the Chartered Management really looked after the books, I believe Aurora

[10] Exhibit 288.
[11] Evidence Volume 93, pp. 12705-9A.

and N.G.K. Investments. The custom had been to send out the annual reports of both companies at the same time and call annual meetings.

In the spring of 1965 we sent out the N.G.K. annual report and called an annual meeting for early June. They did not send the Aurora Leasing report out.

So on 31st March, I believe, the dividend cheques were due on Aurora Leasing and N.G.K., and I believe the interest cheques were due. So since we had a substantial investment in both companies and I was going to be away the next week, I went over to their office (I think it was Friday afternoon) to get these cheques.

Q. Whose office did you go to?

A. To Chartered Management.

Q. Yes?

A. Which was then in Wagman, Fruitman and Lando on Richmond Street, West. While I was there getting the cheques, I said to the chap—and it could have been Canning (I am not sure) I said: 'What about the Aurora Leasing annual report? When are you going to hold the meeting?'. I think I had already phoned up Harry Wagman and he said it would be held some time later.

He said: 'Well, the annual reports are here'. So I said: 'Well, can I have one?'. So he gave me this annual report which is the first one you referred to. So I took it back to the office and it looked pretty well in line with what Mr. Morgan had projected. He said he thought they would earn 65 cents and so on.

So I immediately had copies made and sent them out to all the people that had been asking about how the company was doing.

Subsequently the N.G.K. meeting got called off. Mr. Steinhart, who was also a noteholder and shareholder in that, called up and asked if I was going to the N.G.K. meeting. I said I intended to. He said he thinks it has been called off. So I called Wagman and Wagman said Morgan could not attend because he had to go to the airport to meet his wife, so it was delayed.

So then the Atlantic thing broke shortly after that, and I went over to our auditor then and I said: 'I hear there is trouble in Aurora and N.G.K. What do you do about calling a directors' meeting to find out just what the score is, and getting the auditors to make a report to us?'

Q. When you say you went to your auditor, are you referring to the auditor of Aurora?

A. No, I went to Jack Punchard of Campbell, Lawless and Punchard, who are the auditors for Annett and Company.

Q. Go ahead.

A. I took advice on what to do, because we had not had any annual meeting and we did not have any annual statement sent out and so on.

He said: 'Well, you just call a directors' meeting and demand the statement'. So we took steps to do that and we had the Aurora meeting

in Solomon, Singer and Rosen's office, and we subsequently had the N.G.K. meeting in David Menzel's office.

In the Aurora meeting I arrived and I brought copies of the statement (I had some of them Xeroxed) and everybody was there except the auditor and of course Morgan wasn't there. The auditor wasn't there.

So Jack Laidlaw had been instructed to have the auditor there (Jack Laidlaw was president).

Q. Yes?

A. So there was some confusion as to why Harry Wagman couldn't come. He was busy with a client.

Q. Is this now July 1965?

A. That would be June, late June.

Q. Yes, after the collapse?

A. I think we had the Aurora meeting the last week in June and the N.G.K. in early July.

Q. Go ahead please.

A. So we said, we told him to call back and say we were going to stay there until he came. So in due course Mr. Lando arrived.

Meanwhile I had handed out these statements so everybody had a chance to look at them.

Q. Was there any comment on the statements?

A. The only comment was Mr. Steinhart who said that there is nothing wrong with Aurora Leasing looking at this statement.

Just about that stage Mr. Lando arrived and he wanted to know where these statements came from. I said, I told him where I got this statement, and he said that wasn't the audited statement. With that he handed out a schedule of the people that owed money to Aurora that he had prepared for the Clarkson Company.

So we started to have a discussion on that, and it was decided that that was useless at this stage, and a letter was then written to the Clarkson Company asking them to make a report to the directors of Aurora on the state of affairs in Aurora. That is all that was done.

Q. Did Mr. Lando further explain his observation that the statement which you had was not the audited statement?

A. He just said it was not the audited statement.

Q. Was it signed by Wagman, Fruitman and Lando?

A. Yes, signed, and signed by two directors.

THE COMMISSIONER: Did he at that meeting have the second statement to which counsel has referred, the one with the—

A. No.

Q. —heavily qualified report?

A. No. What they handed out at the meeting was the schedule of the loans that Aurora Leasing had made.

MR. SHEPHERD: Did anyone ask him how this first document came into existence if it was not what it is purported to be?

A. No, it was sort of—everybody was upset. Carl Solomon was the chairman of the meeting. He wanted to do one thing and he wanted to review all these loans. Well, there was no point reviewing all loans, because we didn't know anything about them. So the meeting just sort of adjourned without any further discussion."

If King's memory was not at fault, and it was Canning who gave him the Aurora statement, the latter was employed by Chartered Management Consultants and had rejoined that company, after some two years absence, only in February. He was, none the less, an experienced book-keeper, nearing sixty years of age, who had been employed by Morgan, Walton and Wagman to make the delicate entries in the books of Valley Farm and Enterprises for the "directors' loans payable" account of that company. King's story does not support that of Lando who said he had several copies of the statement "done up" for Morgan and delivered to him by Harry Wagman; Lando's explanation of how what was supposed to be a draft statement, prepared for discussion with the Aurora directors, came to include a settled figure for the bad debts allowance is not convincing.[12]

"Q. At the time that the financial statement was made up apparently in final form and signed on behalf of the firm, but upon the understanding that there would first be an opportunity to discuss the statement with the directors before it would be sent out, was it the position that the allowance for losses was still subject to change?

A. I had no reason to think it would change at all, none whatsoever.

Q. Well, except that there was information which you wanted, and questions which you had directed, to which you did not yet have the reply—isn't that correct?

A. No. I would request that before submitting a report to shareholders, but there were no indications at the time that there would be any changes, and I seem to recall Mr. Morgan suggesting that he hoped the reserve would be accepted by the Tax Department. I thought he was intimating it might be a bit high and he would probably have some trouble justifying it, but he felt it was fair.

Q. How much was the reserve?

A. It was $100,000. I believe it was zero the year before, but it was $100,000.

Q. I take it from what you have said that that was not arrived at by specific allocation of reserves against specific debts, but was an overall figure; is that correct?

A. I would assume that is the way he did it, yes.

[12] Evidence Volume 83, pp. 11236-7.

Q. And it was actually Mr. Morgan who set that reserve; is that correct?
A. That is right.

Q. Mr. Morgan was not a director or officer of that company. Did you regard him as the operating head of it?
A. Yes, I did.

Q. As indeed he was?
A. I felt he was, yes."

The allowance required for bad debts in the case of Aurora Leasing Corporation was, in Mr. Orr's opinion, $5,453,500; this was some $48,000 more than the aggregate of the accounts receivable "specifically assigned" to Commodore Sales Acceptance. The total required allowance considered necessary, on the basis of the information available at the end of 1964, in respect of four of these five accounts was $2,100,000. The figures, seen in juxtaposition, appear to require further comment.

| | *Net Amounts Owing (Less Reserves)* | *Required Allowance for Bad Debts* |
|---|---|---|
| Evermac Office Equipment | $2,101,561 | $1,000,000 |
| Associated Canadian Holdings | 1,122,597 | 250,000 |
| Cimcony of Canada | 544,156 | 100,000 |
| Freeport International | 1,755,014 | 750,000 |
| Mortgage Trust & Savings | 255,410 | — |
| | $5,778,738 | $2,100,000 |

The total shown for "re-discounted notes" in note 1 in the financial statements of March 9, 1965[13] was $5,407,691.30, and the difference between this figure and that of $5,778,739 above represents accrued interest of $371,047, also deducted by Wagman, Fruitman & Lando from both assets and liabilities in the balance sheet of that statement for December 31, 1964. Deduction of the same amount has been reflected in the "Analysis of Accounts Receivable and Bad Debt Allowance Requirements" for Aurora Leasing Corporation, shown in Appendix H, to reconcile the total receivables with the figure of $14, 252,594 on the balance sheet of the second statement prepared in July,[14] to which the amount of accrued interest in respect of the accounts "specifically assigned" to Commodore Sales Acceptance does not appear to have been restored. Several explanations for the selection of these accounts for transfer to Commodore Sales Acceptance may be suggested, but it seems probable that the main purpose of the adjusting

[13]Exhibit 294.
[14]Exhibit 295.

entry was to maintain the relationship of pledged receivables to secured notes payable at just over 125% for the inexpert eye of W. P. Gregory, as the balance sheet of March 9 succeeds in doing on its face. I have no doubt that the first financial statements prepared for Aurora Leasing for the year ended December 31, 1964, on which an unqualified opinion was expressed by Wagman, Fruitman & Lando, were produced for a purpose and a dishonest purpose at that. After Atlantic Acceptance went into receivership it was essential to produce statements which reflected the true position and to qualify their opinion in relation to the allowance for bad debts, to which they had not at any time directed their attention in the past, and about which they professed to know nothing in July 1965.

Disciplinary measures taken against Martin Fruitman and Albert Lando have already been described. Since Harry Wagman was expelled from the Institute of Chartered Accountants of Ontario as a result of his conviction for defrauding Valley Farm and Enterprises Limited, it is of only academic interest, but of interest none the less, to consider the charges against him which the Professional Conduct Committee of the Institute proposed to prefer to the Discipline Committee at the same time. There were seven in number and provide a convenient measurement of his professional shortcomings:

> "**Charge 1:**
>
> That, contrary to the provisions of Rule 5 of the Rules of Professional Conduct, approved June 3, 1963, the said Harry Wagman associated himself with certain reports which he knew or should have known were false or misleading in that the firm of which he was a partner, Wagman Fruitman & Lando while acting as auditor of Commodore Sales Acceptance Limited, Adelaide Acceptance Limited and Aurora Leasing Corporation Limited for the year ended December 31, 1964 expressed unqualified opinions indicating that the financial statements of the aforesaid companies presented fairly the financial position of the aforesaid companies and the results of their operations when the said Harry Wagman was aware or should have been aware that the allowances for doubtful accounts, as stated in the books and on the financial statements of the aforesaid companies, were grossly understated.
>
> **Charge 2:**
>
> That, contrary to the provisions of Rule 3(c) of the Rules of Professional Conduct, approved June 3, 1963, the said Harry Wagman failed to maintain the standards of competence which the Institute and its members have established in that while the firm of which he was a partner, Wagman was a partner, Wagman, Fruitman & Lando, expressed opinions Sales Acceptance Limited, Adelaide Acceptance Limited and Aurora Leasing Corporation Limited, for the year ended December 31, 1964 he failed to perform a careful scrutiny of the loan portfolios of the aforesaid

companies and to assemble information and prepare an analysis of the loan portfolios of the aforesaid companies in order to effectually assess the probable recovery in respect of the loans of the aforesaid companies.

**Charge 3:**

That, contrary to the provisions of Rule 7 of the Rules of Professional Conduct, approved June 3, 1963, the said Harry Wagman as a partner in the firm of Wagman, Fruitman & Lando which acted as the auditor of Commodore Sales Acceptance Limited, Adelaide Acceptance Limited and Aurora Leasing Corporation Limited for the year ended December 31, 1964 failed to obtain sufficient information to warrant expression of an opinion in that he failed to perform a careful scrutiny of the loan portfolios of the aforesaid companies and to assemble information and prepare an analysis of the loan portfolios of the aforesaid companies in order to effectually assess the probable recovery in respect of the loans.

**Charge 4:**

That, contrary to the provisions of Rule 6(b) of the Rules of Professional Conduct, approved June 3, 1963, the said Harry Wagman as a partner in the firm of Wagman, Fruitman & Lando which acted as auditor of Commodore Sales Acceptance Limited, Adelaide Acceptance Limited and Aurora Leasing Corporation Limited for the year ended December 31, 1964 failed to report a material mis-statement known to him to appear in the financial statements of the aforesaid companies in that the allowances for doubtful accounts as stated in the books and on the financial statements of the aforesaid companies were grossly understated.

**Charge 5:**

That, contrary to the provisions of Rule 3(b) of the Rules of Professional Conduct, approved June 3, 1963, the said Harry Wagman in certain professional matters failed to subordinate his personal interests to those of his client in that while the firm of which he was a partner, Wagman Fruitman & Lando was acting as auditor of Commodore Sales Acceptance Limited, Adelaide Acceptance Limited and Aurora Leasing Corporation Limited for the year ended December 31, 1964 it was necessary to evaluate certain receivables from companies in which the said Harry Wagman held a personal interest and in so evaluating the said receivables the said Harry Wagman failed to assess the probable recovery in respect of the said receivables and to report that the allowances for doubtful accounts, as stated in the books and on the financial statements of Commodore Sales Acceptance Limited, Adelaide Acceptance Limited and Aurora Leasing Corporation Limited were grossly understated.

**Charge 6:**

That, contrary to the provisions of Rule 8 of the Rules of Professional Conduct, approved June 3, 1963, the firm of which the said Harry Wagman was a partner, Wagman, Fruitman & Lando, expressed opinions on the financial statements of Commodore Sales Acceptance Limited, Adelaide Acceptance Limited and Aurora Leasing Corporation Limited for the year ended December 31, 1964, when the said Harry Wagman

held such an interest in the aforesaid companies that it could have influenced the independence of the said Harry Wagman and the firm of Wagman Fruitman & Lando without disclosing such interest in the reports containing the aforesaid opinions.

**Charge 7:**

That, contrary to the provisions of Rule 3(a) of the Rules of Professional Conduct, approved June 3, 1963, the said Harry Wagman failed to maintain independence while the firm of which he was a partner, Wagman Fruitman & Lando, acted as auditors of Commodore Sales Acceptance Limited, Adelaide Acceptance Limited and Aurora Leasing Corporation Limited for the year ended December 31, 1964 in that the said Harry Wagman was:

(a) A director of American Marsh Pumps (Canada) Limited, Associated Canadian Holdings Limited, Dallas Holdings Limited, Masco Construction Company Limited and Valley Farms and Enterprises Limited;

(b) An officer of American Marsh Pumps (Canada) Limited, Dallas Holdings Limited, Masco Construction Company Limited and Valley Farms and Enterprises Limited;

(c) A shareholder of American Marsh Pumps (Canada) Limited, Associated Canadian Holdings Limited, Aurora Leasing Corporation Limited, Canada Motor Products Limited, Dallas Holdings Limited, Frederick's Department Store Limited, Masco Construction Company Limited and Valley Farms and Enterprises Limited;

(d) A bookkeeper and/or auditor of American Marsh Pumps (Canada) Limited, Associated Canadian Holdings Limited, Aurora Leasing Corporation Limited, Canada Motor Products Limited, Frederick's Department Store Limited, Masco Construction Company Limited, Pro Musica Limited, Treasure Island Properties Limited, and Valley Farms and Enterprises Limited;

all of which companies were borrowers from Commodore Sales Acceptance Limited or Adelaide Acceptance Limited or Aurora Leasing Corporation Limited and the said Harry Wagman associated himself with auditor's reports of the aforesaid companies which expressed unqualified opinions indicating that the financial statements of the aforesaid companies presented fairly the financial position of the aforesaid companies and the results of their operations."

It will be seen that these charges refer only to situations in which it can be clearly demonstrated that Wagman had the knowledge, or the means of knowledge, as auditor of Commodore Sales Acceptance, Commodore Factors, Adelaide Acceptance and Aurora Leasing, of the true state of their accounts receivable; as preceding chapters of this report have shown, he and his partners had a much more extensive knowledge available to them of situations which, for the most part, had been created by the ingenuity of C. P. Morgan and the active assistance of Wagman and

W. L. Walton. The gross understatement of the allowance for bad debts required in connection with the audits of these four companies played a decisive part in preserving the appearance of profitability in the years 1963 and 1964, and even of solvency in 1964, and without the conspiracy of these accountants with C. P. Morgan, Atlantic Acceptance would have been revealed to the public early in 1964 as tottering, and early in 1965 as prostrate. But this manner of creating fictitious profits is not exclusively responsible for the illusion which Morgan had created, and other accounting devices, with which he was familiar and had applied throughout his direction of the affairs of Atlantic Acceptance, must be examined.

* * *

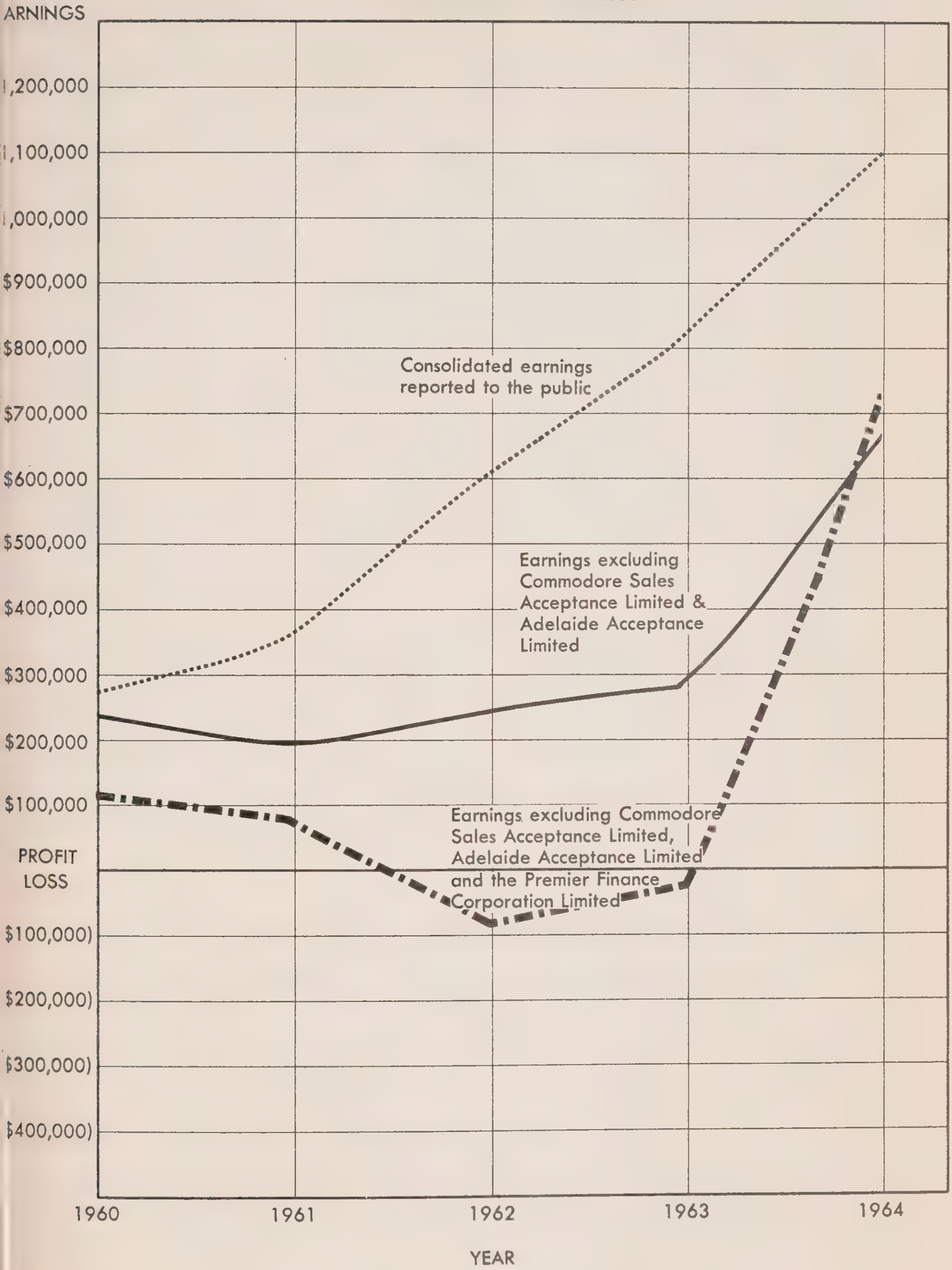
### The Significance of the Subsidiaries

Since C. P. Morgan, from the earliest days of Atlantic Acceptance Corporation, regarded bad debt allowances as an inconvenient limitation upon profits which, at any time that these were imperilled, should be correspondingly curtailed, it is not surprising that their understatement should have been a characteristic feature of the accounts of Atlantic Acceptance; at a critical period in the company's history the understatement of those of the Adelaide Street subsidiaries and the Premier Finance Corporation was so exaggerated, as compared with those set for the Oakville companies, as to provoke the suspicion that the consolidated financial statements of Atlantic Acceptance Corporation had been a sham for at least two, and possibly three years before the company defaulted on its obligations. It was therefore necessary for the Commission to ask its accounting advisers for an illustration of what the consolidated earnings would have been if the four subsidiaries had been excluded or non-existent. This was one of the many considerable tasks assigned in the course of the inquiry to Mr. Alan W. Moreton, C.A. who gave the results of the study in evidence before the Commission on November 10 and 16, 1966.[1] His analysis of the earnings of Atlantic Acceptance and its subsidiary companies from 1960 to 1964 may be summarized by the graphic illustration shown on the opposite page.[2] It will be seen that the consolidated earnings of the group, as reported to the public, flow smoothly upward, from a profit of $270,424 in 1960 to $1,100,004 in 1964, represented by a dotted curve on the graph. If the profits of the Adelaide Street companies had been excluded from the consolidated earnings the result, as shown by the solid line, would have been less satisfactory in appearance; in 1960 they would have been $238,701, declining markedly in 1961 to $189,021; in 1962 and 1963

[1]Evidence Volumes 80-1.
[2]Exhibit 3628.

ATLANTIC ACCEPTANCE CORPORATION LIMITED
AND SUBSIDIARY COMPANIES

ANALYSIS OF EARNINGS



they would have risen only slightly to $244,084 and $280,960; finally, in 1964 they would have shown a substantial rise to $668,741, chiefly as a result of the reported profits of the small loan operations of Atlantic Finance Corporation. When it is considered that Atlantic Acceptance was borrowing large sums in the money market for the sale of secured notes in order to maintain and increase the pace of its lending, and that these operations which attracted the favourable attention of important investors, particularly in the United States, would have been seriously hampered if a relatively static record of earnings had prevailed until 1964, the vital importance of Morgan's recondite manipulations in the Toronto executive offices can be appreciated.

If a further step had been taken and the reported earnings of the Premier Finance Corporation eliminated, the public would have had timely warning of the essential insecurity of Atlantic Acceptance as a sales finance company; its earnings over the period would have appeared as shown by the heavy broken line on the graph, and for 1962 and 1963 losses would have been recorded in the amounts of $88,994 and $34,248 respectively. In 1964, however, the reported profit would have been $710,716, a dramatic improvement which shows the extent not only of the profitability of Atlantic Finance Corporation but of the sad state of affairs existing at Premier Finance, which had virtually ceased operating in 1964 and had surrendered the collection of its soft goods receivables to Standard Discount. But, of course, the Adelaide Street companies were in fact operating and sustained immense losses in 1964 on any fair basis of accounting, and Atlantic Acceptance was not profitable in that sense on a consolidated basis even in 1964. The effect of reporting losses in 1962 and 1963 on the ability of Atlantic Acceptance to finance its lending can only be guessed at, because of the interdependence of many factors in the situation when contemplated in the round, but that it would seriously have impeded Morgan's rise to power and riches there can be no doubt.

**Analysis of the Earnings: Evidence of A. W. Moreton**

The complex calculations resulting in the simple and expressive graph on page 1409 were further illustrated by four schedules, the first and most elaborate of which may be seen in Table 76,[1] described as "Schedule showing the effect of Commodore Sales Acceptance Limited (with its subsidiary Commodore Factors Limited) and Adelaide Acceptance Limited on the earnings and financial position of the Atlantic Complex". The first and upper section of the schedule is a condensation of the consolidated balance sheets for the Atlantic group of companies reported to the public for the fiscal years 1960 to 1964 inclusive, and at

[1]Exhibit 3627.

the date of the receivership order made on June 17, 1965. The middle section, under the heading "Earnings and Capital Raised", deals with the earnings published and the sources of capital from borrowings or the issue of shares in each year; it segregates earnings of Commodore Sales Acceptance (including Commodore Factors) and Adelaide Acceptance in a form described as "adjusted for income transfers" through calculations which are explained hereafter. These figures are followed by the earnings of the other companies in the group the accounts of which were consolidated, and the total consolidated earnings reported from which are deducted the dividends paid in each year; then borrowings, and the proceeds of issues of preference and common shares, are added to the retained earnings and show the apparent continual inflow of new funds. A one-line section in the schedule shows the advances made to Commodore Sales Acceptance and Adelaide Acceptance during each year; below this appears a condensation of the consolidated balance sheets as they would have appeared from year to year had these two companies not existed; in this section it has been assumed that Atlantic Acceptance would not have needed to borrow from the public the sums advanced to the Adelaide Street companies, and the figures for borrowings are correspondingly reduced; finally the shareholders' equity is restated to eliminate the effect of reported earnings and of income transferred by the Adelaide Street companies in payment of interest charges and management fees.

Counsel dealt with this important schedule shown as Schedule 1 to Table 76 with some particularity and since the clarity of Mr. Shepherd's questions and Mr. Moreton's answers can scarcely be improved upon, the following extract from the transcript of evidence, dealing with the year 1963 as an illustration, is given at length.[2]

> "Q. Perhaps you would take one of those years and now explain the approach which you have taken in setting out the figures on this schedule?
>
> A. I select the year 1963 as an example. At the top of the sheet under the heading 'Condensed Consolidated Balance Sheet' I have shown the amounts recorded by Atlantic Acceptance being the consolidated balance sheet which they published and gave to the public.
>
> Q. Yes.
>
> A. These figures have been condensed merely to show the highlights.
>
> Q. And what is the next portion of your schedule?
>
> A. The second portion deals with the earnings as published, and the sources of capital, either through borrowings or the issue of shares in each year during the period.

[2]Evidence Volume 80, pp. 10764-71.

Q. Turning to 1963, where do we see the consolidated earnings as reported?

A. The third figure in the column.

Q. Is that $814,943?

A. $814,943[3] is the figure of earnings published in the audited financial statements.

Q. Yes. Then I see on the two lines immediately before that you have recorded 'Earnings—Commodore Sales and Adelaide adjusted for income transfers,' on one line, and below that you have recorded 'Earnings—other'. What are you doing there?

A. At this point we have segregated what we believe to be the real earnings of Commodore Sales and its subsidiary and Adelaide from the earnings of the remaining companies in the complex.

Q. And for the moment, I take it, then, you are leaving in under the heading 'Earnings—other', the earnings of Premier Finance, is that correct?

A. Yes.

Q. So looking at your schedule, I observe that you state first that the amount of earnings reported by Atlantic to the public is approximately $815,000 and you have calculated that of that amount $533,443 was generated or alleged to be generated by Commodore Sales and Adelaide, and the sum of $281,500 is attributed to all the other companies in the complex, is that correct?

A. That is correct.

Q. What percentage approximately of the total reported earnings during that year came from Commodore Sales and Adelaide?

A. 65%.

Q. Dealing with these alleged earnings of Commodore Sales and Adelaide, can you assist us as to the degree to which you consider them to be factual?

A. I would suggest that these earnings were in effect fictitious.

Q. Do you have any reference to Mr. Orr's evidence, or any exhibit numbers which supported that conclusion?

A. Mr. Orr made reference to these figures in Exhibit 3477 and 3478.

THE COMMISSIONER: Specifically, I believe, to these figures in 3478, would it be?

MR. SHEPHERD: Yes, Mr. Commissioner.

Q. Did you make any examination of your own whereby you were able to say you were in agreement with Mr. Orr's description of these earnings as being fictitious?

A. Yes.

[3]These figures were subsequently slightly amended in Table 76.

Q. What would these companies have shown for, let us say, the year in question if the statement had been prepared in accordance with generally accepted accounting principles?
A. Are you speaking of Commodore—

Q. Commodore Sales Acceptance and Adelaide. I do not want the precise figure. Would they have shown a profit?
A. No, they would have shown a loss if this statement had been prepared in accordance with generally accepted accounting principles.

Q. Then looking at your schedule 3627 again, you record the earnings of all companies other than the 100 Adelaide Street subsidiaries as being $281,500. How much did the company pay out in dividends that year?
A. The company paid $556,263 in dividends.

Q. Is that the figure appearing immediately below the reported consolidated earnings?
A. That is correct.

Q. How much of that was required to be paid out on the preference shares alone?
A. The preference shares alone dividend requirements called for $272,000.

Q. I take it then that in 1963, without the inclusion of non-existent earnings from the 100 Adelaide Street companies, Atlantic on a consolidated basis would just have made sufficient profit to enable it to pay the dividends on the preference shares, is that correct?
A. That is correct, barely.

Q. I appreciate that we will come in a moment to the effect of Premier in detail, but with the profit of Premier in respect of which evidence has been given to the effect that it too was fictitious, would the company then have made enough money to pay the dividends on its preference shares?
A. No, the company would have made a loss.

Q. Now, what are you showing in the remainder of this paragraph of your schedule? You are referring to borrowing during the period and the like?
A. I have shown up to now the purported source of funds from profits of the company of $814,000, out of which dividends were paid of $556,000, leaving a sum of $258,000 odd which would appear to have been an in-flow of funds through profit.

Q. Yes.
A. Following that is a figure showing the net increase in borrowings by Atlantic during the year of $25,000,000.

Q. Yes?
A. And following that figure again is the proceeds of new share issues during the year, capital stock sold to the public, of $1,576,000, which

would make an apparent total in-flow of new funds for the year of $26,862,000.

Below that figure again, I have shown the amounts of the additional loans made to the Commodore Companies and Adelaide during that year, which total $9,367,000.

Q. I take it then these companies at 100 Adelaide Street were not returning cash to the Atlantic complex?

A. No, they were continually drawing cash out; they were not returning cash to the parent company at any time.

Q. From your examination of the records of these subsidiaries and speaking in general terms, for what purposes were these moneys continually withdrawn from Atlantic, being used?

A. These moneys were needed to continue their operations which were generally making loans, further loans, and greater loans of a type which were already existing.

Q. Yes?

A. And in addition funds were needed to prevent old loans from being obviously in default, by the necessity of the parent company advancing money to a subsidiary in order to enable the subsidiary to pay interest thereon.

Q. Now, in the latter part of this schedule entitled 'Balance sheet excluding Commodore and Adelaide', what are you doing there?

A. I have shown the balance sheet which would have existed if the 100 Adelaide Street subsidiaries had not been in existence.

For these purposes I have presumed that if Atlantic did not have to have these three subsidiaries, it would have not been required to borrow from the public the amount of money equal to the amount which Atlantic was loaning to these three subsidiaries. Accordingly I have adjusted downward the amount of borrowed capital.

Q. I see. Just to make this plain before you go on, in the upper part of the schedule under 'Condensed consolidated balance sheet' against borrowed capital, you have recorded approximately $75,000,000. I take that to be the amount which had actually been loaned by the public to the Atlantic complex at the end of 1963?

A. That is right.

Q. Then down below under 'Balance sheet excluding Commodore and Adelaide' I see you have borrowed capital at approximately $48,750,000?

A. Yes.

Q. Do I understand you to be saying that you reduced the amount of borrowed capital which Atlantic would have had if it had not had these three subsidiaries, by a sum equal to the amount which Atlantic loaned to these subsidiaries?

A. Yes, that is correct. At this point it was approximately $26,000,000."

The Adelaide Street companies contributed to the profits of Atlantic Acceptance as a parent company by the payment of management fees to it, which were not, in any sense, related to reimbursement of moneys expended on the management of these subsidiaries, but were in fact transfers of alleged profits by them, and by paying a rate of interest on funds advanced to them which was higher than the rate paid by the parent company itself to borrow the money; then, with their own net profits after paying these charges, they contributed to the consolidated profits of the Atlantic group. The process of adjusting or restating earnings after eliminating arbitrary transfers of income from Commodore Sales Acceptance and Adelaide Acceptance is shown by the following calculation:[4]

COMMODORE SALES ACCEPTANCE LIMITED CONSOLIDATED
AND ADELAIDE ACCEPTANCE LIMITED
EARNINGS ADJUSTMENTS

| | *1960* | *1961* | *1962* | *1963* | *1964* |
|---|---|---|---|---|---|
| *Earnings as per the financial statements* | | | | | |
| Commodore Sales Acceptance Limited—consolidated.......... | $23,578 | $ 88,620 | $109,096 | $142,172 | $191,121 |
| Adelaide Acceptance Limited...... | — | — | 173,192 | 34,006 | 11,361 |
| Total........................ | 23,578 | 88,620 | 282,288 | 176,178 | 202,482 |
| Add back— | | | | | |
| Management fees paid............ | 12,000 | 112,000 | 72,442 | 250,000 | 100,000 |
| Intercompany interest profits paid to Atlantic Acceptance............ | 7,973 | 48,448 | 90,432 | 251,328 | 358,353 |
| Less: Income tax adjustments...... | (11,828) | (81,737) | (81,226) | (144,063) | (229,572) |
| Restated earnings after eliminating arbitrary income transfers......... | $31,723 | $167,331 | $364,036 | $533,443 | $431,263 |

This records the reported earnings for these subsidiaries, including, of course, Commodore Factors, in the years 1960 to 1964 and, by adding back management fees and interest profits paid to Atlantic Acceptance and deducting the amounts of income tax had these transfers of income not been made, produces the net earnings of the subsidiaries after eliminating the effect of the arbitrary income transfers to the parent company. The result is the first line under "Earnings and Capital Raised" shown on Table 76, and is an essential step in showing the effect on the consolidated balance sheets of the Atlantic group, excluding the Adelaide Street subsidiaries. It is normal accounting practice, in consolidating the statements of a parent company and its subsidiary, to eliminate the effect of income transfers such as management fees and inter-company interest paid or received as between companies in a consolidated group. In 1960, before Adelaide Acceptance became a subsidiary of Atlantic, the reported profit of Commodore Sales Acceptance was $23,578, but it had paid in the course of earning it $12,000 in management fees to the

[4]Table 76, Schedule 2.

parent company and interest of $7,973 on money lent to it in excess of what it had cost the company to borrow these funds. The restated earnings before income tax would have been $43,551, attracting tax of $11,828, and the net contribution to the consolidated earnings of the Atlantic group $31,723. In 1962, the first year in which the operations of Adelaide Acceptance were taken into account, the Adelaide Street subsidiaries reported a profit of $282,288, but paid management fees of $72,442 and interest profits of $90,432; from this $81,226 would be exigible for income tax and the restated earnings $364,036. A quick glance at the amount of management fees paid over these years will confirm their arbitrary character. Commodore Sales Acceptance, for instance, in 1960 paid $12,000 and in 1961 $112,000, whereas in 1962 both companies paid only $72,442, rising in 1963 to $250,000 and declining in 1964 to $100,000. It is manifest that the amount of management fees required by Atlantic Acceptance was set by C. P. Morgan with respect to these subsidiaries, over which he had unfettered control, solely with a view to producing an appearance of continuous profitability in the parent company and to control the incidence of taxation from year to year; the fixing of the rate of interest paid by them to the parent company was a less flexible instrument, but equally arbitrary in its use.

Another illustration of the significance of the Adelaide Street companies in the presentation of the financial statements of Atlantic Acceptance and its subsidiaries to the public was provided by Mr. Moreton to show the amount of the consolidated assets utilized by them in relation to their earnings, both as reported and as restated after adjustment for arbitrary income transfers.[5]

ATLANTIC ACCEPTANCE CORPORATION LIMITED
PERCENTAGE OF EARNINGS RETURNED IN RELATION TO PERCENTAGE OF ASSETS USED
BY COMMODORE SALES ACCEPTANCE LIMITED AND ADELAIDE ACCEPTANCE LIMITED

| | 1960 | 1961 | 1962 | 1963 | 1964 |
|---|---|---|---|---|---|
| **Assets used:** | | | | | |
| Total assets of Atlantic Acceptance (less unearned interest) | $17,100,000 | $33,816,000 | $59,371,000 | $86,245,000 | $126,007,000 |
| Investment in and advances to Commodore Sales and Adelaide Acceptance | 1,229,000 | 6,842,000 | 16,810,000 | 26,178,000 | 40,875,000 |
| Percentage of Assets used by Commodore Sales and Adelaide Acceptance | 17.3% | 20.2% | 28.3% | 30.4% | 32.4% |
| **Earnings as reported:** | | | | | |
| Total consolidated earnings of Atlantic Acceptance | $ 270,424 | $ 356,352 | $ 608,120 | $ 814,403 | $ 1,100,004 |
| Earnings reported by Commodore Sales and Adelaide Acceptance | 23,578 | 88,620 | 282,278 | 176,178 | 202,482 |
| Percentage of total earnings reported | 8.7% | 24.9% | 46.4% | 21.6% | 18.4% |
| **Earnings after adjustment for arbitrary income transfers:** | | | | | |
| Total consolidated earnings of Atlantic Acceptance | $ 270,424 | $ 356,352 | $ 608,120 | $ 814,403 | $ 1,100,004 |
| Restated earnings of Commodore Sales and Adelaide Acceptance | 31,723 | 167,331 | 364,036 | 533,443 | 431,263 |
| Percentage of total earnings returned | 11.7% | 47.0% | 59.9% | 65.5% | 39.2% |

[5] Table 76, Schedule 4.

It will be seen that the total assets of Atlantic Acceptance and all of its subsidiary companies, less the unearned interest reserves against them, rose from $17,100,000 at the end of 1960 to $126,007,000 at the end of 1964. During this period the investment in and advances to Commodore Sales Acceptance and Adelaide Acceptance also rose at an accelerated rate from $1,229,000 to $40,875,000; considered at the end of 1964, 32.4%, or almost one-third of the total assets were employed by the Adelaide Street subsidiaries. Their earnings are also displayed, as reported and as adjusted for arbitrary income transfers, as a percentage of the total reported and of the total returned or provided. During Atlantic's critical period of growth from 1961 to 1964 the Adelaide Street companies employed anywhere from 20% to 32% of the total assets of the Atlantic group of companies, but provided from 39% to 65% of the total profits, based on their earnings as restated in the manner which has been described. The most striking contrasts are provided during the year 1963 when Commodore Sales Acceptance and Adelaide Acceptance utilized 30.4% of total assets and reported 21.6% of total earnings, thus apparently reversing the position of the previous year where they used 28.3% of the assets and reported 46.4% of the earnings; nevertheless the restated earnings proved to be 65.5% of the total for the group, or more than 5% greater than the very large proportion for 1962. The reason for Commodore Sales Acceptance and Adelaide Acceptance becoming less significant as an element in the consolidated profits for 1964 was the fact that in this year the Oakville companies, for the first time, reported a substantial profit on their own account.

The significance of this will not be lost when it is realized that Atlantic's borrowings in 1964 were assisted by its published financial statements as at December 31, 1963. In this connection C. P. Morgan, in his twelfth annual report to the shareholders introducing the financial statements at December 31, 1964, referred to the gratifying results in the following terms:[6]

> "During the year the Company placed privately $1,500,000 Canadian and $10,000,000 U.S. Senior Notes and $550,000 Canadian and $2,500,000 U.S. Junior Subordinated notes. Late in November 240,000 common shares were issued from which the Company realized $4,320,000. From this base, for the purpose of future borrowings, the Company's growth in 1965 is assured"

Again it must be emphasized that it was essential to Morgan's grand illusion that the Adelaide Street subsidiaries continue to show substantial profits not open to question by independent auditors, and that these

[6]Exhibit 45.

profits should be consolidated in order to present a picture of glowing health for Atlantic Acceptance and its subsidiaries as a whole; that these profits were fictitious, and based, as already seen, on a massive understatement of allowances required for bad debts, was the heart and soul of the deception.

Yet another aspect of the contribution of the Adelaide Street subsidiaries must be considered before leaving the subject. Looking again at Table 76 in which all the relevant figures are assembled, it will be seen that in 1961, out of consolidated earnings as reported of $356,352, Commodore Sales Acceptance's contribution was $167,331 and those of "others" $189,021; out of these dividends in the amount of $155,295 were paid. Had the Adelaide Street subsidiaries been excluded there were sufficient reported earnings to cover the dividend payment, but in 1962 a dividend payment of $291,671 would not have been covered by the earnings of the "others" in the amount of $244,084. They would have sufficed still less in 1963 when, without Commodore Sales Acceptance and Adelaide Acceptance, earnings were only $280,960, and dividends were paid out in the total amount of $556,263 of which $272,000 alone was required for the preference shares. Even in 1964, when the Oakville companies first reported significant profits, the earnings of "others" amounted to $668,741, insufficient to meet dividend payments of $727,741. Because of the high rate of dividend paid each year which Morgan considered essential as a means of attracting new capital and loans, very little of Atlantic's cash required for growth was supplied by retained earnings; these in 1960 amounted to $229,633, fell back in 1961 to $201,057, rose only slightly in 1962 to $316,449, again fell back in 1963 to $258,140 and rose again to only $372,263 in 1964. During these years the Atlantic group was raising money as expansion capital in amounts of anywhere from $7,000,000 to $37,000,000 annually, and the sums advanced to the Adelaide Street companies during the period were a considerable part of the total cash available to it. In 1960, for instance, out of $7,351,817 available in new funds, $1,211,000 was advanced to Commodore Sales Acceptance, and in 1961, out of $15,164,810 in hand, $5,532,845 was advanced. In 1962 new funds amounted to $25,262,924 of which $9,968,632 was lent to Commodore Sales Acceptance and Adelaide Acceptance; in 1963 it was $9,367,162 out of $26,862,294 and in 1964, $14,697,786 out of $38,142,848 went to the Adelaide Street subsidiaries. Nevertheless profits appeared to come back with a vengeance after having been invested in loans so inadequately secured that proper bad debt allowances would have revealed the truth; as it was, assets utilized by the Adelaide Street subsidiaries were proportionately less than the apparent earnings provided by them to the group as a whole.

Mr. Moreton also subjected the operations of the Premier Finance Corporation to the same analysis.[7] Between 1960 and 1963 this wholly-owned subsidiary of Atlantic Acceptance Corporation, acquired in 1959 and carrying on business in Toronto, reported substantial earnings but ceased operations, other than collecting part of its own receivables, in 1964. The figures showing its restated earnings, after eliminating management fees and interest profits paid to Atlantic Acceptance, are displayed below, together with the percentage of total reported earnings contributed by it for the years 1960 to 1963 inclusive, and the results of excluding the restated earnings of the Adelaide Street companies together with those of Premier Finance in the annual operations of the group as a whole.

PREMIER FINANCE CORPORATION LIMITED
EARNINGS ADJUSTMENTS

| | *1960* | *1961* | *1962* | *1963* | *1964* |
|---|---|---|---|---|---|
| **Earnings as per the financial statements** | $ 94,520 | $101,293 | $187,620 | $ 66,629 | ($ 67,339) |
| Add back—Management fees paid | 50,000 | — | 215,000 | 100,000 | — |
| Intercompany interest profits paid to Atlantic Acceptance | 4,947 | 30,582 | 46,794 | 76,398 | 54,108 |
| | $149,467 | $131,875 | $449,414 | $243,027 | ($ 13,231) |
| Less—Income tax adjustment | 23,604 | 11,732 | 120,336 | (72,181) | 28,744 |
| **Restated earnings after eliminating arbitrary income transfers** | $125,863 | $120,143 | $329,078 | $315,208 | ($ 41,975) |
| Percentage of Total Earnings Reported | 46.5% | 33.7% | 54.1% | 38.7% | — |
| Consolidated Earnings as Reported | $270,424 | $356,352 | $608,120 | $814,403 | $1,100,004 |
| Less: Restated Earnings of Commodore Sales, Commodore Factors & Adelaide | 31,723 | 167,331 | 364,036 | 533,443 | 431,263 |
| | $238,701 | $189,021 | $244,084 | $280,960 | $ 668,741 |
| Less: Restated Earnings of Premier Finance | 125,863 | 120,143 | 329,078 | 315,208 | (41,975) |
| Restated Consolidated Earnings or (Loss) excluding the above subsidiaries | $112,838 | $ 68,878 | (84,994) | (34,248) | $ 710,716 |

The bottom line represents the figures from which the lowest curve was plotted on the graph at page 1409. The profits of Premier Finance were also fictitious in the same sense as were those of the Adelaide Street subsidiaries and in 1960 were of far greater significance as a contribution to the earnings of the Atlantic group than were those of Commodore Sales Acceptance; thereafter until 1964 they continued to be a necessary element in the presentation of Atlantic Acceptance to the public as a profitable enterprise. In 1962 and 1963, for instance, the consolidated earnings of the Oakville companies together with Standard Discount Corporation, Pay As You Study Plan and Concourse Agencies would have shown a loss of $84,994 and $34,248 respectively; it should be said as well that at no time during the period 1960 to 1964 had these companies sufficient profit to pay the dividends which Atlantic Acceptance in fact paid to the public on an ascending scale in those years. One item in the above tabulation that does not appear to be of the same order as the figures shown in connection with the Adelaide Street subsidiaries

[7]Table 76, Schedule 3.

is the income tax adjustment for 1963, which is added rather than subtracted to express the restated earnings of Premier Finance for that year. While Premier Finance in 1963 would have provided $243,027 of the profits of the consolidated group, the actual loss to it, had Premier Finance not existed, would have been $315,208. Atlantic Acceptance itself operated at a loss during that year, but had substantial deferred expenses in connection with the cost of opening and developing newly established branches and with the issue of shares and notes which it could write off for purposes of income tax by transferring to itself the Premier profits as payment of management fees and excess interest charges; if these profits had not been transferred and the earnings of Premier Finance not consolidated, those of the Atlantic group would have been lower by $315,000.

Nothing has been said so far to distinguish the operations of Standard Discount Corporation, the Toronto finance company incorporated as a private company in June 1949 and wholly acquired by Atlantic Acceptance in October 1961. Its business was conducted separately from all the other subsidiaries in straightforward fashion by its president Samuel G. Baker who had as co-directors C. P. Morgan, Alan T. Christie and A. C. Rooney, the last-named being replaced by David Davidson in June 1964. Its profits were at all times moderate and reasonably calculated, and for this reason its earnings were included by Mr. Moreton with those of the Oakville subsidiaries in his analysis of those of the Atlantic group of companies. Nevertheless Standard Discount did provide a striking example of how Morgan was prepared to use management fees charged by Atlantic Acceptance to enhance its apparent profitability. The following memorandum from P. E. Prowse, chief accountant at the head office in Oakville, was addressed to S. G. Baker on January 14, 1964:[8]

> "The attached invoice for additional Management Fees should be handled on the books of Standard in the following manner:

| | | |
|---|---|---|
| Management fees Atlantic Acceptance Corporation Ltd. | $50,000.00 | |
| Atlantic Acceptance Corporation Ltd. | | $50,000.00 |
| To record additional management fees. | | |
| Reserve for losses | 50,000.00 | |
| Provision for losses | | 50,000.00 |
| To reduce the Reserve for losses by $50,000.00 | | |

> As you can see, the net effect of both of these Journal entries is to leave your income for the year unchanged."

[8]Exhibit 3629.

As observed previously management fees from a subsidiary to a parent, being merely a transfer of income between them and eliminated on consolidation of the financial statements, have no effect on the reported profits of a consolidated group of companies, but the direction to reduce the reserve for losses by the amount of the increased fee would have had the effect of raising the profits of the group by $50,000. Mr. Baker and his auditors, Stone, Anger, Conway & Stone, apparently stuck to their guns, because the suggested entry does not appear in Standard Discount's books. On the auditors' working sheet,[9] in which they arrived at an estimate of the allowance for bad debts for 1963 of $115,385, there appears a note reading:

| | | | |
|---|---|---|---|
| "C.P.M. would like allowance— | 10% | of 3 mos. | 12,000 |
| | 15% | of 4 mos. | 13,000 |
| | 20% | of 5 mos. | 63,000 |
| | | | 88,000" |

This would indicate that Morgan wished to calculate it on a certain percentage of each class of overdue accounts to produce an aggregate allowance of $88,000 only. Such a reaction to a suggestion of C. P. Morgan, then at the height of his authority and influence over the affairs of Atlantic's subsidiaries, provides a refreshing contrast to the servile complicity of Walton, Wagman & Co. whose members were deeply involved in the affairs of the debtors of the companies for which they acted as auditors, and of E. M. Sprackman, Siderson & Co., auditors of Premier Finance, whose senior partner was a director of Racan Photo-Copy Corporation, one of the former company's largest debtors.

**Accounting Devices at Oakville**

Thus far I have considered the evidence of Mr. Orr as to what independent auditors would have considered to be the proper allowance required for losses in respect of bad debts, had they been called upon to express an unqualified opinion upon the consolidated financial statements of Atlantic Acceptance Corporation after conducting the audit of it and all its subsidiary companies, and the evidence of Mr. Moreton as to the part played particularly by three of those subsidiaries, Commodore Sales Acceptance (with its own subsidiary Commodore Factors), Adelaide Acceptance and the Premier Finance Corporation in creating an illusion of profitability for the whole group from 1960 to 1964, audited as were the first and second by Walton, Wagman & Co. and its successor firm, Wagman, Fruitman & Lando, and the third by E. M. Sprackman, Siderson & Co., if the involvement of these firms in their affairs can be so dignified by the use of that term. With respect to Mr. Orr's evidence

[9]Exhibit 3589.

I have carefully considered that given by Harry Wagman, A. Martin Fruitman and Albert M. Lando in their appearances before the Commission, and the written submission of the last two accountants subsequently, annexed as Appendix M, and I have reached the conclusion that nothing that they have said or written alters my opinion that the profits of these subsidiary companies as returned to Atlantic Acceptance were fictitious because of a gross and calculated understatement of the required allowances. Similarly I adopt Mr. Moreton's view, as derived from his analysis of their accounts, that without the aid of these subsidiaries Atlantic Acceptance would not have been able to appear to the public as a profitable operation from the end of its fiscal year in 1961 until the results for 1964 had been reported early in 1965, and that in respect of 1961, indeed, its financial position would have been shown to have declined in comparison to 1960. The consequences of the truth having become apparent at any time during these four years would, in my opinion, have so affected the public, and especially that section of it which provided Atlantic's life-blood by buying its shares and notes, as either to prevent the final catastrophe in June 1965 or to anticipate its result to such an extent that I would not have been called upon to consider the causes and effects of the enormous losses actually sustained. There remains, however, to be considered the degree to which C. P. Morgan's ingenuity affected the operations of Atlantic Acceptance itself and its Oakville subsidiary companies, of which Atlantic Finance Corporation was by far the most considerable and in 1964 was apparently set upon a conventional and prosperous path for the future. At this point it should be said that, in concluding that the allowances for bad debts required for the operations of the Oakville companies in 1963 and 1964 were acceptable, Mr. Orr's opinion was confined to this important, but necessarily narrow aspect of their accounting practices. No treatment of these would be complete, or useful to the public, if other accounting practices used in the computation of the earnings of Atlantic Acceptance as a sales finance company group were overlooked.

The business conducted at 505 North Service Road, Oakville, can be divided into four separate categories:

(a) small loans made directly to the borrower of less than $1,500 by Atlantic Finance Corporation as regulated by the Small Loans Act, R.S.C. 1952 c.251 administered by the Department of Insurance at Ottawa;

(b) large direct loans over $1,500, not subject to the provisions of the Small Loans Act, and in the main carried on the books of Atlantic Finance Corporation;

(c) Conditional sales contracts purchased from dealers and carried on the books of Atlantic Acceptance Corporation; and

(d) miscellaneous loans, including those on the security of inventory, usually made to dealers supplying conditional sales contracts and carried on the books of Atlantic Acceptance Corporation.

**Accounting Treatment of Interest on Loans: The Small Loans Act**

The Small Loans Act was enacted by the Parliament of Canada in 1939 as a result of considerable publicity given to the activities of "loan sharks", and its purpose is conveniently set out in the preamble, a practice now going out of style in drafting legislation.[1]

> "Whereas it has become the common practice for money-lenders to make charges against borrowers claimed as discount, deduction from an advance, commission, brokerage, chattel mortgage and recording fees, fines and penalties, or for inquiries, defaults or renewals, which, in truth and substance are, in whole or in part, compensation for the use of money loaned or for the acceptance of the risk of loss or are so mixed with such compensation as to be indistinguishable therefrom and are, in some cases, charges primarily payable by the lender but required by the lender to be paid by the borrowers; and whereas the result of these practices is to add to the cost of the loan without increasing the nominal rate of interest charged so that the provisions of the law relating to interest and usury have been rendered ineffective: Therefore His Majesty, by and with the advice and consent of the Senate and the House of Commons of Canada, enacts as follows: . . ."

In general terms the scheme of the Act was to regulate the method of computing interest, and to limit the amount charged on loans of $500 or less; in the year that Atlantic Finance was incorporated this limit was raised to $1,500.[2] These amendments limited the cost of a loan made by a small loans company incorporated by special act of Parliament, or by a moneylender licensed under the Small Loans Act (which Atlantic Finance Corporation evidently was) to 2% per month on any part of the unpaid principal balance not exceeding $300, 1% per month on any part of such balance exceeding $300 but not exceeding $1,000 and one-half of 1% per month on any remainder of such balance exceeding $1,000; because of this it was impractical to compute the interest in advance for such loans and frame a contract for the repayment of a pre-computed sum including interest and principal. Accordingly no income was taken up in advance to compensate the company making small loans foi initial expenses of placing them on its books. The only income taken up was that earned on a "true interest basis", or, in other words, derived from the actual amount of money advanced by the lender outstanding at any time.

[1]S.C. 1939 c.23, s.1.
[2]S.C. 1956 c.46, s.1.

It was otherwise with loans over $1,500, the lending and collection of which were not similarly governed by statute, and it has become the custom in Canada for finance companies to calculate in advance the interest payable over the whole life of a loan contract, add it to the amount advanced and provide for regular repayments of equal size, including principal and interest, over a stipulated period. The full amount payable under the contract is then placed on the company's books as an asset, offset by a deferred revenue account entitled "unearned interest". There has, however, been some difference of opinion in the industry as to the method of taking interest income into account, but most companies agree that the costs of placing a new contract on their books, such as clerical and advertising expenses, must be considered an element of the interest charge. It is customary in consequence to take some portion of the total interest to be earned at once into income to compensate the lender for the "cost of acquisition" of the loan. The distinction in principle between accounting treatment of a loan for $1,499, where no interest is pre-computed, and one of $1,501, where it is, is not readily apparent.

The practice of computing interest in advance is also normally applicable to conditional sales contracts, where title to the goods to be sold remains with the vendor or his assignee until the full amount of the contract has been paid. These are usually purchased by finance companies from retailers of automobiles, construction equipment, electrical appliances and other commodities, and in most cases it is customary to pay the dealer a portion of the interest income to be earned as a "dealer rebate" or commission. Most of the paper held by Atlantic Finance did not require such rebates because its loans were generally made direct to the borrower, but Atlantic Acceptance, which in the normal course of its business acquired conditional sales contracts, usually rebated from 10% to 15% of the total pre-computed interest on each to the dealer from which it was purchased. Inventory and wholesale loans made directly to dealers were nevertheless treated like small loans and the interest receivable taken into income as it was earned.

### The Deferment of Interest Income and the Rebate Test

The method of taking into income over the life of the contract of that portion of the interest which is deferred, known as the "Rule of 78ths", has already been described in Chapter II[1] and can perhaps be more accurately referred to as the "sum-of-the-digits" method, since 78 is only the sum of the digits for a total of twelve periods, applicable to a one-year contract in which the deferred income would be taken up to the extent of 12/78ths of the balance in the first month, decreasing to 1/78

[1]pp. 42-3.

in the twelfth. The practice is generally accepted in the industry and is illustrated in the "Instructions to the Borrowing Company" which preface the Canadian Sales Finance Long Form Report, adopted on March 23, 1967 by the Federated Council of Sales Finance Companies and developed by it, in conjunction with the Investment Dealers Association of Canada, as the minimum standard of information required for reporting on the operations of sales finance companies doing business in this country. Here it is described as the "Direct Ratio Method" and is illustrated as follows:[2]

"As applied to a 12-month contract acquired on the first day of the month:

| | |
|---|---|
| Total initial finance charge | $100.00 |
| Less | |
| acquisition charge | 0.00 |
| dealer reserve | 0.00 |
| other expense items | 0.00 |
| Net initial finance charge | $100.00 |

Amount of finance charge taken up—

| | |
|---|---|
| in the 1st month (month of acquisition) | $15.39 |
| in the 2nd month | 14.10 |
| in the 3rd month | 12.82 |
| in the 4th month | 11.54 |
| in the 5th month | 10.26 |
| in the 6th month | 8.97 |
| in the 7th month | 7.69 |
| in the 8th month | 6.41 |
| in the 9th month | 5.13 |
| in the 10th month | 3.85 |
| in the 11th month | 2.56 |
| in the 12th month | 1.28 |
| Total | $100.00" |

If, however, the various methods—and this is not the only one—of taking the deferred or unearned portion of the pre-computed interest into account are considered acceptable in the industry, a good deal of controversy surrounds determination of the proper portion of it which should be taken up forthwith as the "cost of acquisition".

In his eleventh annual report to the shareholders, contained in the published report of Atlantic Acceptance Corporation Limited and subsidiary companies for 1963, C. P. Morgan made the following statement:[3]

"As mentioned in our 1962 report, I.B.M. equipment was installed during the year and certain statistics which we did not have are now

[2] Exhibit 4634.
[3] Exhibit 44.

> obtainable. When a check of our deferred income was run off on an individual account basis by the new equipment, it was found that an additional amount was required to bring this account into line. This major adjustment was charged against 1963's gross income and in no small way affected our earnings. I should point out that this only defers the income from 1963 into 1964 and early 1965 when it will be taken into earnings as the receivables are paid off."

This cryptic reference to the introduction of data processing equipment, which allowed management for the first time to examine the anatomy of individual accounts receivable in relation to that of the whole Atlantic operation, refers to the culmination of a process long advocated by Wright, Erickson, Lee & Macdonald as auditors. According to the evidence of Mr. J. E. Lee of that firm, they recommended in 1962 that Atlantic take up income on the sum-of-the-digits basis, and that a firm of management consultants be engaged to review its whole system and to supervise the installation of tabulating equipment.[4] As it turned out the approach to management consultants was only perfunctory; it was not until 1963 that the equipment was installed, and November of that year before it was put to use on the individual accounts. The proposal had evidently been resisted because of the clerical cost of making the entries in the case of a large number of loan accounts, an excuse which was no longer valid once the equipment was installed. It will be necessary to return in a moment to consider the method, if such it can be called, by which Atlantic Acceptance and Atlantic Finance took unearned interest into income before November 1963, but from then on in the case of retail paper, which was by far the largest in volume purchased by these companies, the sum-of-the-digits method was used, and 40% of the total pre-computed interest on any contract was taken into income at once representing the cost of acquisition. The full benefit of this was felt only by Atlantic Finance which usually paid no dealers' rebate, whereas Atlantic Acceptance remitted 12% of the total amount to dealers, retaining only 28% of the total pre-computed interest as an increase in its profits in the first month of the contract, amounting to 28/88ths or 32% of the net pre-computed interest. In this connection it is instructive to note that Industrial Acceptance Corporation announced, in the "Supplementary Information on Balance Sheet Items" annexed to its annual report for 1965,[5] that 7% of the pre-computed interest on advances over $1,500 was taken into income in the first month of a contract and the balance of 93% credited to income over a period one month longer than the term of the contract, using the sum-of-the-digits method. Mr. Moreton was advised that Traders Finance Corporation

[4]Evidence Volume 79, pp. 10739-40.
[5]Exhibit 3909.

(now known as Traders Group) on the same basis used a rate of 20% on loans in excess of $1,500 made directly to the borrower, 15% for conditional sales contracts and 7½% for moneys lent on the security of "mobile homes", a trade description of semi-permanent residential trailers towed from place to place by automotive tractors; this would represent an average of 18% on all accounts. When General Acceptance Corporation took over the Oakville operations of Atlantic in 1965 it considered 25% on those accounts which required a dealers rebate (Atlantic Acceptance accounts) and 15% on direct loans (Atlantic Finance accounts) were reasonable percentages of the pre-computed interest to be taken into income at once as the cost of acquisition.

There is little doubt, based on this comparison and in accordance with the information generally available to the Commission, that Atlantic's percentage of pre-computed interest taken into income at once as the cost of acquiring a contract was the highest and most imprudent in the industry, with the possible exception of one other company which almost sank into insolvency during the aftermath of the Atlantic failure, and only survived because of a massive injection of new capital contributed by a major shareholder and a radical writing off of bad debts; since these heroic measures were successful and it now appears to be on an even keel, no useful purpose would be served by naming it. The word "imprudent" however is used advisedly, because the more pre-computed interest which is taken up at the beginning of the period over which repayment was designed to run the less there is available for deferment to the future, to correspond with the real incidence of repayment and to provide a reserve against delinquency and prepayment. The result is a distortion of the "true interest basis" on which only income derived from interest payable from time to time on the outstanding balance of a loan is taken into account as it is paid, and in its use of the 40% ratio Atlantic was in effect borrowing income from future periods to enhance its current position. Mr. Orr's description of Atlantic as a "crescendo" company may therefore be easily understood; its income would continue to rise from year to year only as long as the rate of acquisition of new business placed on its books continued to rise as well. If, for example, a state of equilibrium was reached in which loans paid off were simply matched in amount and in terms by loans newly negotiated, the income of such a company would at once begin to decline because of the small proportion of the pre-computed interest originally deferred to be taken into income in subsequent years. The decline would be even more marked in the case of a business recession or a season of restricted credit, such as in fact inhibited Atlantic's borrowing in early 1965.

One useful check on the advisability of taking up excessive income early in the life of a loan contract is known as the "rebate test". Most

contracts for loans over $1,500 on which the interest was pre-computed did not, in the period under consideration, require a rebate to the borrower, if the loan was repaid in advance of its maturity, of the balance of the interest still deferred at the time when prepayment was made; but most finance companies, of which Atlantic Acceptance was one, followed the practice of making a refund of interest subsequently due, based on the sum-of-the-digits method, after charging the customer a modest penalty.[6] An acceptance finance company can quickly perceive the extent to which its practices may be considered conservative by assuming that all its customers or borrowers present themselves and offer prepayment of their loans at the same time at their face value, plus penalty and less the rebate usually allowed. If the value at which these accounts receivable are carried on the company's books, minus the unearned interest as deferred income, is less than the amount which would be received on prepayment by all customers after paying them rebates at the usual rate, the company has passed the test.

Such a test is applied by Industrial Acceptance Corporation, the largest Canadian finance company, as indicated in its annual report for 1965, but was not used by Atlantic Acceptance. It is desirable to see what the results of such a test would have been had it been made by Atlantic Finance Corporation taking up the full 40% of pre-computed interest as the cost of acquisition at a time material to this inquiry. The calculation shown hereunder[7] was produced by Mr. Moreton and adapted from an example of the calculation of rebate taken from standing instructions of Atlantic Finance.

ATLANTIC FINANCE CORPORATION LIMITED
"REBATE TEST" APPLIED TO UNEARNED INTEREST

**Example**

Loan made November 20, 1961
Contract paid out by customer January 21, 1962
Original maturity 30 months; original charge $463.84

**Rebate**

The rebate in January, 1962 would be:

| | | |
|---|---|---|
| Sum of the month's digits—81% of $463.84 or | $375.71 | |
| Less: pay-out penalty | 25.00 | |
| Net rebate | | $350.71 |

[6]Rebate has since become mandatory in Ontario under the provisions of the Consumer Protection Act, S.O. 1966 c.23, s.25.
[7]Exhibit 3910.

**Accounting for Unearned Income**

| | | |
|---|---|---|
| Deferral of unearned interest—60% of total charges (40% taken into income in November, 1961) ........ | 278.30 | |
| Less: Interest earned in December on the sum-of-the-month's digits basis ($\frac{24}{300}$ = 8% of $278.30) ........ | 22.26 | |
| Balance in unearned interest account at January 1, 1962 ........ | | 256.04 |
| Overstatement of balance sheet value at December 31 ........ | | $ 94.67 |

Percentage of deficiency in unearned interest account: $\frac{94.67}{256.04} = 37\%$

The first two headings are examples from the manual, and the third, entitled "Accounting for Unearned Income", was the witness's calculation of the overstatement of the value of the contract included in the balance sheet accounts receivable at December 31, 1961, and the percentage of deficiency in the unearned interest account. The result, in simple terms, is that the customer repaying a loan, where the period of the contract was thirty months after only two had elapsed, was entitled, on the agreed scale of rebate less penalty, to a refund of $350.71 out of pre-computed interest charges amounting to $463.84; since only 60% of the total charges had been deferred in the amount of $278.30 when the remaining 40% was taken into income in November 1961, there was only $256.04 in the unearned interest account at January 1, 1962 to meet the refund. The result is a deficiency of $94.67 or 37%.

## Cost of Acquisition as Calculated by Atlantic Prior to November, 1963

Although the taking up of 40% of the interest charges as the cost of acquisition of the loan contract was the most liberal method practised in the industry in Canada in 1964, it was in fact more conservative than that generally in use by Atlantic prior to November of 1963. During 1962, for instance, Atlantic Acceptance and Atlantic Finance did not calculate their unearned interest on each contract, but deferred a percentage of the total outstanding accounts. This percentage was based on the result of calculating what was felt to be a representative contract, reflecting the average length of time for which all contracts were written and for which all contracts had been outstanding. It was assumed that the unearned income outstanding at any given time would be from 6%

to 6.9% of the outstanding balance of all the accounts receivable in which the interest charge had been pre-computed. During 1963 management at Oakville reviewed this arbitrary formula, concluded that 6.9% was not sufficient as an allowance and increased it month by month until November when it had reached the level of 7.5%. The result of adopting in that month a deferment of 60% of the total interest charge in the case of all new accounts mechanically tabulated was to raise the proportion of unearned interest to the total of outstanding receivables to 10%, indicating that fixing the cost of acquistion at 40% of the pre-computed interest charge was considerably more conservative than the arbitrary 6% to 6.9% formula which, as it was applied, resulted in the assumption of 55% to 65% of the interest income as the cost of acquisition.

With regard to the calculations which had prevailed prior to November, 1963 and which, according to David Davidson, C. P. Morgan had adopted after finding the sum-of-the-digits method itself too conservative as a means of taking up income in the years before 1960, J. E. Lee of Wright, Erickson, Lee & Macdonald advised counsel as follows:[1]

> "Q. Now, if they didn't follow the method of the sum of the digits, what method did they follow for setting up a reserve for unearned income?
>
> A. Simply as I explained before, by calculating a percentage of the outstanding balance at the end of the fiscal year.
>
> Q. What percentage was used?
>
> A. In which year?
>
> Q. Take the earliest year, 1954. What percentage was used in that year?
>
> A. I can't go back that far.
>
> Q. Any year?
>
> A. Take 1962; 6.9 per cent.
>
> Q. Did you consider that adequate?
>
> A. We examined it and made some tests with regard to it, and we considered it acceptable. We also considered, of course, as I said before, that this was on the high side of the bracket."

Just what was the extent of Mr. Lee's acceptable bracket was not made clear, and no doubt he intended to say that this method of deferring income was on the "low side". Although the effect of deferment to the extent of 6% of the outstanding accounts receivable, in terms of assigning a percentage of the interest charge taken up on acquisition of a contract, is not "provable mathematically", as Mr. Moreton said, I

[1]Evidence Volume 79, pp. 10740-1.

am satisfied that it amounts to something in the order of 60% and would not be regarded as acceptable by any prudently managed sales finance company.

**Effect on Profits of Various Calculations of the Cost of Acquisition**

Two schedules were produced by Mr. Moreton to show, for the year 1964, the effect on profits of Atlantic Finance Corporation and Atlantic Acceptance Corporation of taking into income, as the cost of acquisition, various percentages of the pre-computed interest of a contract in the first month of its life. These are shown as Table 77[1] in the case of Atlantic Finance, and as Table 78[2] in the case of Atlantic Acceptance. The actual percentages used by the two companies have been shown first, producing a figure for the net deferment of income, and then, under percentages used by other finance companies of 25%, 18%, 15% and 7%, the net deferment is shown, together with the amount by which the adoption of such a percentage would have increased the net deferment over the amount of income actually deferred by each of the companies in that year, or, stated in another way, the amount by which the profit of the two Atlantic companies before taxes would have been reduced by selecting each of the lower percentages. The right hand column in each schedule presents the same results in a situation where all the income is deferred over the life of the contract, and nothing is taken up to represent the cost of acquisition. Taking the case of Atlantic Finance, which in 1964 took up 40% and deferred 60% of the pre-computed interest, it will be observed that at the beginning of 1964, specifically at December 31, 1963, the "interest included receivables" amounted to $5,893,300, and the deferred amount of the pre-computed interest in respect of these was $558,001. If the cost of acquisition had been treated as 25% of the pre-computed charge, deferment would have been $697,500, if 18%, $762,600, if 15%, $790,500, if 7%, $864,900, and if nothing had been taken up to represent it, as in the case of the "true interest basis", $930,000. During the course of the year accounts receivable of this type rose to a total of $13,144,639 at December 31, 1964 and the income actually deferred was $1,634,406; so that, by subtracting the deferment at December 31, 1963 from the deferment at December 31, 1964, a net deferment of income during the year is arrived at in the amount of $1,076,405. If, instead of taking up 40%, Atlantic Finance had taken up 25% and deferred 75% of the pre-computed interest, the net deferment of income during the year 1964 would have amounted to $1,345,508. If 18% had been taken up and 82% deferred, the net amount would have been

[1]Exhibit 3911.
[2]Exhibit 3912.

$1,471,088; if 15% had been taken up and 85% deferred, it would have been $1,524,909; if 7% had been taken up and 93% deferred, $1,-668,429; finally, if nothing had been taken up, all would have been deferred in the amount of $1,794,010. The sums by which the profits of Atlantic Finance before taxes would have been reduced by adopting ratios in an ascending order of conservatism would have been as follows in terms of the percentage taken up as cost of acquisition in the first month of the contract:

| | |
|---|---|
| 25% | $269,103 |
| 18% | $394,683 |
| 15% | $448,504 |
| 7% | $592,024 |
| Nil | $717,605 |

Thus if the rate of 15% used by General Acceptance Corporation had been used by Atlantic Finance as a proper proportion of the pre-computed interest to be taken into income as the cost of acquisition of the contract at the beginning of its life, its profit before taxes at December 31, 1964 would have been reduced by $448,504.

The same calculation of the effect on profits before taxes was made in the case of Atlantic Acceptance and is shown on Table 78. This company, which paid commissions to dealers, was unable to take up more than 32% of the pre-computed interest as the cost of acquisition; in consequence the effect on its profit was proportionately less than in the case of Atlantic Finance. Its "interest-included receivables" rose from $30,519,189 at December 31, 1963 to $44,007,197 at December 31, 1964, in respect of which the net deferment of income during the year was $1,202,687; using the 15% instead of the 32% rate for the cost of acquisition, the profit before taxes of Atlantic Acceptance would have been reduced by $300,671. The combined reduction of the 1964 profits before taxes of both companies under the General Acceptance Corporation's method would have been $749,175; the overstatement of profits in previous years would have been also significant but lower in magnitude, since new accounts taken on to the books in the years before 1964 were substantially less than in that year.

### Disclosure to the Public: The Robert Morris Questionnaire

Other than the soothing but uninformative announcement of C. P. Morgan, already quoted from the president's report for the fiscal year 1963, the shareholders knew nothing of the methods used by Atlantic for taking pre-computed interest on accounts into income. The more knowledgeable could, of course, have drawn the inference that profits in earlier years had been overstated and that everything had then been put right by the ubiquitous computer, but no actual figures were given, nor

any comparisons drawn with previous positions. The noteholders were, however, better informed as a result of the agreement entered into between Guardian Life Insurance Company of America and Atlantic Acceptance Corporation on May 28, 1962, whereby the former agreed to purchase Series J senior notes with a face value of $1,000,000 in U.S. funds, maturing on June 15, 1975 and bearing interest at 6% per annum.[1] These were secured by the fourth supplemental indenture, dated June 8, 1962 and given by Atlantic Acceptance to Montreal Trust Company as trustee; by the terms of the agreement with the insurance company, Atlantic was obliged to furnish, within ninety days after the end of its own fiscal year, a completed questionnaire in the form prescribed by Robert Morris (First National Bank of Chicago), commonly known as the Robert Morris Associates questionnaire. This requirement only became effective at the end of 1963, and thereafter Atlantic supplied all its noteholders with a report entitled "Supplementary Information—Year Ended December 31, 1963", and a similar report for the year ended December 31, 1964 in due course. That report for 1963 contains on its last page, which is chiefly devoted to a table entitled "Balances of Direct Cash Loans and Break-down of Collections", a short note as follows:[2]

> "Acquisition cost is 40% of precomputed interest. Balance of precomputed interest is transferred to earned income over the term of the account as calculated on the 'Rule of 78' ".

The noteholders, therefore, were in a position to know the nature of Atlantic's calculation of the cost of acquisition of a contract and the extent to which income derived from it was deferred to future periods, and to compare it with the methods in use by other finance companies. A comparison, however, of this report with the Robert Morris questionnaire shows that the information which Atlantic gave in the former was neither as complete nor as significant as that required in the latter. A copy of the "Sales Finance Questionnaire" prepared by Robert Morris Associates and in effect in 1962,[3] and their "Commercial Financing Questionnaire",[4] colloquially known as the "yellow sheet", were put in evidence. The former asks if the report includes operations of subsidiary or affiliated companies and if any financing has been done "for concerns in which officers, stockholders, directors of company or their families have a direct or beneficial interest"; this required details not included in the supplementary information provided by Atlantic. The questionnaire also contains the direction: "If commercial and miscellaneous financing operations are engaged in please complete the separate

[1]Exhibit 3439.
[2]Exhibit 92.
[3]Exhibit 3913.
[4]Exhibit 3914.

commercial financing questionnaire". Under these circumstances, the Robert Morris' "yellow form" requires answers as follows:

"1. Does this report include operations of subsidiary or affiliated companies?—If so, please give details regarding (a) the names of subsidiaries wholly or partially owned, (b) the nature of the business, (c) capital outstanding, (d) ownership of reporting company, (e) amount and description of outside financing, (f) nature of intercompany transactions, (g) guaranties, if any.

2. Does the reporting company have any subsidiary or affiliated companies which are not included in this report? —If so, please furnish the data listed above.

3. Is any financing done for concerns in which officers, stockholders, directors of the company or their families have a direct or beneficial interest?—If so, please give details regarding (a) name of company, (b) line of business, (c) types of financing granted, (d) total amount outstanding at statement date, (e) maximum amount outstanding during the period.

4. Does the reporting company or its subsidiaries or affiliates have any contingent liabilities (not set forth above) for guaranties, endorsements, litigation in process or threatened, additional taxes or for any other reason?"

These questions are followed by more detailed requirements for information about the volume of business for the period, reserves for losses, the loss experience for the period and schedules setting forth details of loans secured by accounts receivable, factored accounts receivable, loans secured by inventories and loans secured by plant machinery and equipment. If these questionnaires had been furnished to noteholders, Atlantic would have been required to give details of the operations of Commodore Sales Acceptance, Commodore Factors, and Adelaide Acceptance which would have revealed to discerning eyes particulars of loans in the order of $10,000,000 to Aurora Leasing Corporation, of $7,000,000 to Dalite Corporation (Canada) and other very large advances, with records of repayment which would not have borne scrutiny. The size and concentration of commercial loans would have been so uncharacteristic of normal finance and acceptance business as to have shaken the confidence of experienced purchasers of finance company notes, and the ensuing extract from Moreton's evidence on this subject is pertinent here.[5]

"MR. SHEPHERD: Mr. Moreton, you said that the company was obliged to supply the information on the Robert Morris questionnaire. Did they do so?

A. No.

[5]Evidence Volume 96, pp. 13101-6.

Q. What information was required of them which they did not supply?

A. Well, for one thing the Sales Finance Company questionnaire, Section 1 on the first page asks for information—it asks the question whether or not the report includes operations of subsidiary or affiliated companies. It also asks the question whether any financing was done in concerns in which officers, stock holders, directors of the company or their families have a direct or beneficial interest. This was not included in the information which was given by Atlantic Acceptance.

Q. Yes. What else did Atlantic not reply to which they were supposed to do?

A. At the bottom of the same page, page 1, note (c) the question is as follows:

> 'If commercial or miscellaneous financing operations are engaged in please complete the separate commercial financing questionnaire.'

This was not done.

Q. And is that separate commercial financing questionnaire the yellow sheet, Exhibit 3914?

A. Yes.

Q. If Atlantic, had in fact truthfully completed that form, what would have been disclosed which was new?

A. Well, it would have been required to give details of the subsidiary companies such as Commodore Sales Acceptance, Commodore Factors and Adelaide Acceptance.

Q. What would the result have been?

A. If they had—the result of that would have been, amongst other things, having disclosed these companies, certain concentrations of loans and descriptions of loans which are referred to on page 3, would have become evident; for example, whereas the names of the debtors are not required, it would have been evident that single accounts such as loans to Aurora Leasing for example, would have appeared. Aurora being at that time a ten million dollar loan.

Q. Yes.

A. Which would have caused one, certainly in my reading of the report, to ask for more information.

Other accounts that would have become evident, I think, would have been Conarm, Hugo Oppenheim, Nevil Enterprises, Dalite—

Q. Dalite (Canada), I suppose?

A. Dalite (Canada), Pro-Musica — these accounts by principal or by dollar value would necessarily have been disclosed, and these would have been of comment because of their sheer size.

THE COMMISSIONER: You are now talking about the yellow sheet?

A. Yes.

Q. Yes.

MR. SHEPHERD: Do you consider, Mr. Moreton, that the company would have faced difficulty had they truthfully answered the questions which are on page 1:

> 'Is any financing done for concerns in which officers, stockholders, directors of the company or their families have a direct or beneficial interest?—If so, please give details regarding (a) name of company, (b) line of business, (c) types of financing granted, (d) total amount outstanding at statement date, (e) maximum amount outstanding during the period.'

Is that correct?

A. This would have given great difficulty.

THE COMMISSIONER: Well, did they just leave those items blank, or did they prepare a return of their own? I am talking now about the one they did file, presumably, which is Exhibit 3913, and you said they did not answer Questions 1 and 2 and, of course, they did not complete that note (c)?

A. I should make it clear: At no time did they file one of these forms. What they did file was a brochure which contained information similar to the questions asked on this form.

Q. One of their own devising?

A. And in doing so, they consolidated, or put it another way, they returned all their loans but in categories which did not correspond to the definite categories laid out in either the Sales Finance Questionnaire or the Commercial. They made their categories—for example—they used such headings as 'Leases on commercial equipment', which does not appear in either of them. And, a category called, 'Agriculture'. Another one called 'Soft goods', and another category, 'Installation accounts secured by various other securities'. These are the headings which they reported in their own brochure which do not actually appear here, but all loans are reported.

Q. Yes.

A. In other words, they re-arranged it.

Q. And, apparently, without any expostulation from the lender who prescribed the Robert Morris questionnaire?

A. Yes, that's correct.

MR. SHEPHERD: Well, they typed up, Mr. Moreton, their own form of answers to substantially the questions which were asked, but they deleted answers to some questions such as interest of directors, and they did not answer the questions on the Commercial Financing form at all, or in many instances?

A. Yes, that's right.

Q. And no one complained about it?

A. Not that I know of."

One more observation must be made in considering the persistent tendency to overstate the profits of the Atlantic group of companies. After completing the 1963 audit, Wright, Erickson, Lee & Macdonald insisted on appending note No. 5 to the consolidated financial statement in the following terms:[6]

> "(5) Income taxes:
>
> Atlantic Acceptance Corporation Limited and Atlantic Finance Corporation Limited follow the practice of reducing income, for tax purposes, by deducting deferred costs of developing newly established branches and deferred note and share issue expenses in the year in which these costs are incurred rather than in the year in which they are charged to operations.
>
> In prior years, when the application of these deferred costs resulted in a reduction of income taxes, the income taxes otherwise payable were deducted in arriving at net income and the resulting tax reductions appeared on the balance sheet as 'accumulated income tax reductions applicable to future years'.
>
> In 1963 the companies adopted the practice of reflecting in their statements of income only the income taxes payable for the year. If the prior years' practice had been followed in 1963, net income would have been reduced by $246,257 with an amount of $319,870 appearing on the balance sheet as 'accumulated income tax reductions applicable to future years'. The accumulated income tax reductions of $73,614 which were recorded in prior years have been credited to retained earnings in 1963.
>
> These reductions of income taxes may be offset in future years when the amortization of deferred costs must be added to income for tax purposes. As a result of applying subsidiary companies' losses incurred in prior years the 1962 provision for income taxes was reduced by $91,815."

Davidson suggested in his evidence to the Commission[7] that this insistence was the real reason for the Hamilton firm losing the Atlantic audit, and that it was much resented by Morgan: Lee maintained that Morgan directed no protest to him and that in any event the inclusion of the note was "not debatable". It may well be that this change in accounting practice, and in the computation of income tax, was deliberately made to offset the decrease of income to be expected from the change to a more conservative method of deferring unearned interest by taking up 40% of the pre-computed charge, rather than 55% to 65%, as the cost of acquisition. There is little doubt as things now stand, after the lessons of Atlantic have been pondered and digested, that auditors would now insist upon a note to the financial statements expressing the change in this respect also, and indeed it is difficult to see why one was not required

[6]Exhibit 44.
[7]Evidence Volume 79.

at the time, since both changes made a substantial departure from accounting methods followed in previous years. Certainly Morgan's statement in his president's report was carefully framed to conceal from shareholders the information necessary to their understanding of what had transpired. At the very least it may be said that Wright, Erickson, Lee & Macdonald were, in 1963, as fully entitled to comment upon a change in the method of calculating deferred income as upon a change in the method of computing deferred income tax.

**The Federated Council of Sales Finance Companies**

On May 11, 1967 Mr. Carne H. Bray gave evidence before the Commission, as executive vice-president of the Federated Council of Sales Finance Companies, the national trade association of such companies operating in Canada. The Council, with its head office in Toronto, had, at the time when Mr. Bray testified, 43 members, or somewhat less than a third of such companies operating in Canada; among them, however, were the largest independent operators doing some 70% of the financing of consumer sales in the country, and independent in the sense that they were not an emanation of some particular manufacturer or retailer. Mr. Bray produced a report to this Commission, compiled by his own and other hands and approved by the Council; this was entered in evidence[1] and is annexed as Appendix N to this report. Perhaps its most valuable characteristic is the evidence it provides of the self-examination conducted in the industry as a result of the failure of Atlantic Acceptance in June 1965. The Canadian Sales Finance Long Form Report, already referred to,[2] is appendix 4 to the Federated Council's report to the Commission, and it should be noted that its completion by finance companies in Canada, together with that of the Robert Morris Associates' questionnaires and the furnishing of audited financial statements, is now required by the Investment Dealers' Association of Canada as prerequisite to its members offering finance company obligations for sale in the market. These requirements, because of their uniformity, could successfully prevent the type of evasion which Atlantic Acceptance practised in furnishing supplementary information to noteholders and prospective investors. The Robert Morris Associates questionnaires have now been revised,[3] doubtless due in part to the failure of Atlantic and that of the Pioneer Finance Corporation of Detroit which, although unrelated, followed hard on its heels and caused important losses to the type of small investor who had purchased Atlantic notes. The Federated Council's position on the taking up of a portion of the pre-computed

[1]Exhibit 4634.
[2]p. 1425.
[3]Appendix O.

interest of a loan contract as the cost of acquisition may be read in Appendix N, pp. 53-4 and for convenience is quoted here.

> "The extent to which comparability is assured has been increased by providing definitions of terms used. Where definitions have not been given, the terms represent honest differences of opinion in the industry as to the best way of treating the items. For instance, the direct ratio method of taking up income is probably not used in an unmodified form by any company in the industry. If it were, 'acquisition costs' would not exist. Where the acquisition of contracts does incur costs (and in some classes of business, such as commercial and industrial financing, the costs are not only evident, but high), eliminating the practice of taking these into income would distort the valuation of assets and profits by inflating the asset deferred income during periods of expansion in the economy while deflating profits, and deflating deferred income and inflating profits during contractions. The accounting principle of matching costs with revenues would be violated.
>
> The question remains, 'How much acquisition cost is allowable?' This is another way of asking, 'By how much should the direct ratio method be modified?' for the principle is involved. There is general agreement in the industry that the direct ratio method should be modified according to the class of receivable acquired. There is as yet no agreement as to the degree.
>
> The reason for the lack of agreement is quite clear. What is involved is the tendency towards conservatism. The difficulty arises because that policy which is most conservative during an expansion in the economy (and hence in volume of business acquired), if maintained during contraction periods has the opposite effect. One is faced with two alternatives:
>
> 1. Change the policy as the economy changes—which would destroy year to year comparisons, or
>
> 2. Strike a happy medium which is most appropriate for both expansions and contractions in business—not an easy point to discover and get agreement from all the experts, particularly in today's situation when conservatism is favoured. However, because the problem is clear, resolution cannot be so far away."

Mr. St. Elmo V. Smith, in his submission to the Commission relating to accounts peculiar to finance companies contained in Appendix L, deals at length with the practice of apportioning unearned income to accounting periods under the sub-heading "Practice in Accounting for Unearned Income", and describes the sum-of-the-digits method, the "equal instalment or straight line method", the "average interest method" and the "arbitrary percentage method", concluding as follows:

> "Of the methods outlined, the sum of the digits method is generally regarded as providing the most suitable method by which unearned

> income can be determined, although it is considered by some that the method does not take sufficient income into account in the first month to cover normal initial expenses. This must be judged as a question of fact in the circumstances of any particular case."

When considering the problem of presenting unearned income on a finance company's balance sheet, he proceeds as follows:

> "The practice of deducting unearned finance charges from notes receivable has received authoritative support from professional accounting bodies in the United States and in Great Britain. This treatment is apparently based on one or other of the following theories. One theory is that by deducting unearned finance charges the notes receivable are shown at their principal amount and this amount is comparable with that shown for notes included in the balance sheet on which interest is collected periodically. Another theory is that by showing the net total a more or less present value of the note is displayed. There are also some exponents of the view that the net amount tends to indicate a realizable value.
>
> As indicated in the foregoing section, there are many different practices followed in taking unearned finance charges into income and in my opinion it would be somewhat coincidental if the net balance of notes receivable after deducting unearned income did represent the principal amount, the present value or the realizable value. In respect of the last two, this is particularly apparent when it is considered that either the realizable or the present value will depend on the current cost of borrowing money, funds available to be borrowed, and the demand for such notes at any given time as compared with conditions when the contracts were written. Furthermore, accounting theory is based on the going concern concept in determining amounts at which assets and liabilities are carried on the balance sheet and not a valuation or liquidation approach.
>
> The two largest Canadian finance companies not associated with foreign corporations show unearned finance charges on the liabilities side of the balance sheet. This leaves notes receivable stated in the balance sheet at the amount the debtor has agreed to pay and, assuming there are no bad debts, at the amount that will be received by the finance company on a going concern basis.
>
> Probably it is not a matter of great concern as to whether the unearned finance charges are deducted from the notes receivable or shown separately as a deferred credit in the balance sheet. The matter of prime concern is to indicate the amount of unearned income, the amount of the notes receivable to which it relates and the basis on which unearned income is taken into income account in the profit and loss statement. All of this is important information for the analytical reader of financial statements and in my opinion should be disclosed to shareholders in the annual financial statements and notes thereto. It has not

> been common practice to disclose this information in annual accounts sent to shareholders but it is becoming more readily available to interested parties in supplementary material prepared by finance companies."

Atlantic Acceptance did show on its consolidated balance sheet unearned finance charges on the liabilities side, described simply as "unearned interest"; except, however, in the supplementary information supplied to noteholders for 1963 and 1964, it was silent as to the basis on which unearned income was taken into income account in the profit and loss statement.

From the foregoing it can be assumed that different approaches will be taken by individual companies and auditors to the desirable proportion of unearned interest to be used as the cost of acquisition under different circumstances. The treatment of deferred income may well be regarded as one of the more delicate examples of the accountant's art and, in the comparatively simple matter of deciding whether such income derived from pre-computed interest, spread over the life of a loan contract, should be shown as a deduction from the notes receivable assets or carried in the liabilities section of the balance sheet, two opposite but valid views may prevail. It is, however, quite clear that none of the accounting opinions given or available to the Commission would condone the methods used by Atlantic Acceptance to inflate the profits of its group of companies. These in 1964 were reported as $1,100,004,[4] and some measure of the enormity of this inflation can be judged by observing that, if Atlantic had used a reasonable percentage of pre-computed interest charges to represent the cost of acquisition, the profits of Atlantic Acceptance Corporation and Atlantic Finance Corporation, considered separately, would have been reduced by a combined total of $749,175, and that Commodore Sales Acceptance and Adelaide Acceptance, on the basis of restated earnings, contributed fictitious profits of $431,263; the aggregate overstatement of profit in 1964 may therefore be taken as $1,180,438, or something in excess of the reported figure. That this result can be observed in a year when, for the first time, the genuine acceptance and finance business of Atlantic showed signs of true profitability, however distorted by the accounting devices described, is perhaps sufficient comment on the ingenuity and iniquity of C. P. Morgan's conduct of the affairs of the group during the whole period under review.

On the question of disclosure there would now seem to be no divergence of view, except for the position taken by the Federated Council of Sales Finance Companies, that prior to the collapse of Atlantic it was not customary for Canadian finance companies to furnish the information to prospective investors in Canada that was generally

[4]Exhibit 45.

required by those in the United States. The current view, which must in very large measure be attributed to the heavy losses incurred as a result of the Atlantic débâcle and its unfavourable effect upon the finance company industry as a whole, is that disclosure in bewildering profusion should be offered to the public. Yet it is doubtful if a small investor, and particularly that type who is easily persuaded by the prospect of higher yields to invest in worthless notes such as those of Prudential Finance Company Limited, which was not a finance company at all, is much enlightened by what is vouchsafed. In particular it would appear that the language of prospectuses is still unduly larded with cant phrases which can only be translated into plain English by those few who can understand them or read between the lines, and the simplification of these documents should be the concern of all regulatory bodies. But the provision of detailed information to experienced investors, from which professional advisers and market analysts can draw correct conclusions, is clearly useful. In the first place it is difficult to falsify, and deliberate falsification may and should attract condign punishment; in the second place, particularly if it is provided by companies seeking to sell their obligations in the money market on a uniform basis, it should provide useful comparisons as between one company and another from which experts can draw accurate conclusions as to the stability of the company soliciting public funds, and disseminate simple and intelligible conclusions to the public in due course.

### The Heart of the Matter

Without attempting to summarize previous sections of this chapter which has dealt at some length with the constituent parts of the grand illusion created by C. P. Morgan, by which Atlantic Acceptance Corporation and its subsidiaries were made to appear profitable in increasing measure when in fact they were not, I must record my view that, without the dishonest complicity of the auditors of the Adelaide Street companies which is beyond doubt, and those of Premier Finance Corporation which may be inferred, he would not have succeeded as he did. It would therefore seem essential to return to the attitude taken by the governing bodies of the accounting profession in this country to the extent to which auditors of the consolidated financial statements of a parent company and its subsidiaries can rely on the opinion of other auditors on the financial statements of the subsidiary companies. Bulletin No. 22 of the Committee on Accounting and Auditing Research of the Canadian Institute of Chartered Accountants, which appeared in August 1965, is a milestone, and its relevance to this aspect of the Commission's inquiry so important as to require its reproduction in full.

"ACCOUNTING AND AUDITING PRACTICES

Statements Issued By

The Committee on Accounting and Auditing Research

of

The Canadian Institute of Chartered Accountants

Bulletin No. 22

AUGUST, 1965

## RELIANCE ON OTHER AUDITORS IN REPORTING ON CONSOLIDATED FINANCIAL STATEMENTS

Auditors are frequently in the position of reporting on consolidated financial statements which incorporate the accounts of subsidiaries which have been examined by other auditors.

The problems which this may involve, both for the auditor of the parent company and that of the subsidiary, have been a matter of interest to the Committee on Accounting and Auditing Research for some time. In July 1964 the Committee authorized the publication of a Research Study 'Reliance on Other Auditors' which included a review of practices in Canada, the United States and England. As a result of the findings of the Research Study, the Committee on Accounting and Auditing Research thinks it useful to issue a Bulletin on the subject of reliance on other auditors as related to consolidated financial statements.

In giving consideration to this Bulletin, it is important that the reader should have some understanding of the legal implications. Although several of the Companies Acts in force in Canada make provision for presenting consolidated financial statements to shareholders, the Companies Acts are silent as to the position of a parent company auditor reporting on consolidated financial statements when he is not the auditor of all the consolidated subsidiaries.

Legal advice has been taken, and in the opinion of counsel the duty of the parent company auditor is to exercise reasonable care to ascertain that the consolidated financial statements present fairly the financial position and results of operations of the parent company and its consolidated subsidiaries. Counsel has been unable to find any Canadian or British legal decision defining what would be reasonable care on the part of the parent company auditor as regards the accounts of a consolidated subsidiary of which he is not the auditor. However, because it has been held that an auditor is justified in acting upon the opinion of an expert where special knowledge is required, counsel has expressed the opinion that, having exercised due care, it would be reasonable for a parent company auditor to rely on the report of the auditor of the subsidiary, on the footing of the latter being an expert and possessing special knowledge not available to the parent company auditor.

While in the absence of any court decision or statutory provision, no positive assurance can be given as to the respective legal positions of

parent and subsidiary company auditors, this Bulletin has been reviewed by counsel and is issued to provide guidance to members on this matter.

In this Bulletin, the Committee does not purport to make any pronouncement on the subject of the interrelationship of the auditors and reliance on their respective opinions in any other situation than that which exists where the accounts of a subsidiary are incorporated in consolidated financial statements.

The problems involved in reliance on other auditors in expressing an opinion on consolidated financial statements fall into two broad categories:

(a) Where the auditor of the subsidiary company is the agent of the parent company auditor or where the parent company auditor is prepared to accept the work of the other auditor as though he were his agent for this particular assignment.

(b) Where no agency relationship exists.

Within each of these categories, the problems may be dealt with under two main classes:

(i) Responsibility for the work done by the auditor of the subsidiary company.

(ii) Disclosure of the work done by the auditor of the subsidiary company.

## AGENCY RELATIONSHIP

### RESPONSIBILITY

Situations where an agency arrangement exists between the two auditors include those cases where the parent company auditor enters into an arrangement with another public accountant to carry out the examination of the accounts of the subsidiary company or where the subsidiary company auditor is an affiliate or correspondent of the parent company auditor.

In such cases, it is clear that the parent company auditor is taking full responsibility, so far as the consolidated financial statements are concerned, for the work of the other auditor. In addition to his responsibility to the shareholders of the subsidiary company, the other auditor is also responsible, as agent, to the parent company auditor.

In other situations the parent company auditor may be prepared to accept the work of the other auditor as though he were his agent for the particular assignment, in which case the acceptance of responsibility is unilateral. Before assuming such a responsibility the parent company auditor may wish to review the working papers of the other auditor and/or make some overriding examination of the accounts of the subsidiary.

### DISCLOSURE

In the above circumstances the parent company auditor should not make any reference to the work or the report of the other auditor. The auditor's report on the consolidated financial statements would normally follow the recommendations of Bulletin 17, suitably changed for consolidated financial statements.

## NO AGENCY RELATIONSHIP

### RESPONSIBILITY

In the circumstances where no agency relationship exists between the parent company auditor and the auditor of one or more of the subsidiary companies, the parent company auditor may reasonably rely on the subsidiary company auditor's work and opinion as sufficient supporting evidence for the accounts of the subsidiary included in the consolidation, provided he has taken reasonable care to assure himself that such reliance is justified to the purpose of forming an opinion on the fairness of the consolidated financial statements.

The Committee considers that steps taken by the parent company auditor to entitle him to rely on the work and opinion of the subsidiary company auditor should normally include:

(a) Assurance that the subsidiary company auditor is an independent practising public accountant, licensed where required or otherwise appropriately qualified.

(b) Direct communication with the subsidiary company auditor to ensure that he is aware:

 (i) That the audited financial statements of the subsidiary are to be included in the consolidated financial statements; and that his work and opinion will be relied on by the parent company auditor for the purpose of forming an opinion on the consolidated financial statements.

 (ii) Of the financial reporting requirements relevant to the consolidated financial statements.

(c) Consideration of the content of the report of the subsidiary company auditor as supporting the credibility of the related financial statements.

(d) Enquiry into the extent to which the accounting policies reflected in the financial statements of the subsidiary company differ from those of the parent company or from those followed in the preceding year.

In addition, the parent company auditor may consider it necessary to enquire into the scope of the examination conducted by the subsidiary company auditor.

The enquiries referred to above may be made by any methods reasonable in the circumstances, such as personal consultation, correspondence or review of working papers. The degree of enquiry made will be determined by the auditor of the parent company, having regard to the materiality of the accounts of the subsidiary company and all other circumstances in each individual case.

The Committee considers that the parent company auditor is entitled to rely on the work and opinion of the subsidiary company auditor if, having followed the above procedures and any others that might be indicated by the particular circumstances, he has no reason to doubt the validity of the financial statements of the subsidiary company.

The Committee considers that the subsidiary company auditor has a professional obligation to comply with requests for information of the nature referred to above, recognizing that such requests result solely from the responsibility imposed on the parent company auditor in reporting on consolidated financial statements.

### Disclosure

In the above circumstances, a report on the consolidated financial statements in the following form is recommended where statutory requirements permit:

## AUDITOR'S REPORT

To the Shareholders of

..............................................................................

I have examined the consolidated balance sheet of ............................ as at ........................................ and the consolidated statements of income and surplus for the year ended on that date. My examination of the financial statements of ................................(the parent company) and those subsidiaries[1] of which I am the auditor included a general review of the accounting procedures and such tests of accounting records and other supporting evidence as I considered necessary in the circumstances. I have relied on the reports of the auditors who have examined the financial statements of the other subsidiaries.[1]

In my opinion the accompanying consolidated balance sheet and consolidated statements of income and surplus present fairly the financial position of the companies as at ..........................and the results of their operations for the year ended on that date, in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

(signed)..............................................
Chartered Accountant

The Committee considers that a reference to the work of another auditor in the manner recommended above does not constitute a qualification of the opinion of the parent company auditor, but is made to demarcate the scope of the examination by stating clearly his reliance on the report of the other auditor. If qualifications are needed, either as to the acceptability of the report of other auditors or as to other matters in the accounts of the subsidiary, they should be made in specific terms and an exception taken or no opinion given as the circumstances may dictate.

[1]The wording of the auditor's report may require appropriate adaptation in the event that there are non-consolidated subsidiaries.

## MATERIALITY IN THE MATTER OF RELIANCE ON OTHER AUDITORS

Where the financial statements of subsidiaries, with respect to which the parent company auditor is relying on the work of other auditors are

> not material in the consolidated financial statements, the parent company auditor may be prepared to accept full responsibility for the work of the other auditors so far as the consolidated financial statements are concerned, even in the absence of any agency relationship, express or implied. In these circumstances the same considerations as those outlined in paragraphs 8, 9, 10 and 11 would apply.
>
> Where, on the other hand, no agency relationship exists but the financial statements of subsidiaries with respect to which the parent company auditor is relying on the work of other auditors are so material in the consolidated financial statements that the parent company auditor cannot satisfy himself personally concerning a substantial proportion of the whole, he must consider whether it is appropriate for him to express an opinion on the consolidated financial statements."

It should be appreciated that these are well-weighed words, proceeding from lengthy and exact deliberation by leading members of the accounting profession in Canada; they are not intended to catch the eye of the public or the press, but are addressed to fellow-members on a serious and perplexing subject. Moreover they represent a considerable advance upon generally accepted opinion prior to the Atlantic collapse. It will be seen that where an "agency relationship" exists or, in other words, where the auditor of the parent company as principal appoints the auditor of the subsidiary company as his agent, there is no doubt about the former assuming full responsibility for the work of the latter, and that he is invited to review the working papers of his agent and to make "some overriding examination of the accounts of the subsidiary". In such a case he makes no reference in his report to the work of other auditors on the statements of a subsidiary company, because he is *not* relying upon it but is adopting it in effect as his own.

Here there is a problem of semantics to be faced. The word "rely", as used in the first, or "scope" paragraph of the draft opinion approved by the committee, is divorced from any hint of a guarantee. It will be recalled that Deloitte, Plender & Co., in reporting on the consolidated statements of Atlantic Acceptance in 1964, not only referred in the scope paragraph to the fact that the accounts of certain subsidiaries had been audited by other accountants, but inserted in the second, or "opinion" paragraph that their own opinion was, in so far as the consolidated accounts were affected by those of the subsidiary companies not examined by them, "based solely on the reports of other chartered accountants". The form of auditors' report approved in the bulletin relegates any reference to other auditors to the scope paragraph, apparently to guard against any false impression, derived from its inclusion in the opinion paragraph, that some qualification of the opinion has been made.

The most important part of the bulletin, from the point of view of measuring the change in professional opinion which it reflects, is contained in the section headed: "No Agency Relationship". In paragraph 13 the committee recommends that the parent company auditor should be entitled to take certain steps to satisfy himself as to the reliability of auditors, not being his agents, of subsidiary companies, and in paragraph 15 he is advised that the inquiries recommended in paragraph 13 may include "personal consultation, correspondence, or review of working papers". Cautious as these words may appear to be to the uninstructed reader, their significance is very great, because if any steps of a like nature had been taken by either of the firms of chartered accountants which successively audited the consolidated accounts of Atlantic Acceptance, the cat would have been out of the bag with a vengeance.

The attention of the Commission has been directed to only one pronouncement later than Bulletin No. 22, which, incidentally, will shortly appear, re-named, as a "Research Recommendation" in the new Canadian Institute of Chartered Accountants' Handbook, and this is the report of the Canadian Institute's Special Committee on Shareholders' Audits, reproduced in "Canadian Chartered Accountant" for November 1968. The relevant portion of this important pronouncement dealing with reliance on other auditors is also reproduced as printed in that publication hereunder.

> "G—RELIANCE ON OTHER AUDITORS
>
> An auditor is sometimes required to report on consolidated financial statements which include the accounts of subsidiaries for which he is not the auditor but which have been examined by other auditors. The Corporations Acts now in force in Canada are silent as to the auditor's responsibility in such circumstances, although an amendment has been introduced as a bill in the Ontario Legislature which deals with this matter. Research Bulletin No. 22, issued in August 1965, entitled 'Reliance on Other Auditors in Reporting on Consolidated Financial Statements' provides that even in the absence of any agency relationship between the auditors, the parent company auditor may reasonably rely on the subsidiary company auditor's work and opinion as sufficient supporting evidence for the accounts of the subsidiary included in the consolidation, provided he has taken reasonable care to assure himself that such reliance is justified in relation to the purpose of forming an opinion on the fairness of the consolidated financial statements. The Bulletin then goes on to set out the steps which the parent company's auditor should take, in the following terms:
>
> '(a) Assurance that the subsidiary company auditor is an independent practising public accountant, licensed where required or otherwise appropriately qualified.

(b) Direct communication with the subsidiary company auditor to ensure that he is aware:

(i) That the audited financial statements of the subsidiary are to be included in the consolidated financial statements; and that his work and opinion will be relied on by the parent company auditor for the purpose of forming an opinion on the consolidated financial statements.

(ii) Of the financial reporting requirements relevant to the consolidated financial statements.

(c) Consideration of the content of the report of the subsidiary company auditor as supporting the credibility of the related financial statements.

(d) Enquiry into the extent to which the accounting policies reflected in the financial statements of the subsidiary company differ from those of the parent company or from those followed in the preceding year.'

The Bulletin recommends that where the parent company's auditor has relied on the reports of other auditors on subsidiary companies' accounts, the opinion of the auditor on the consolidated accounts should indicate that he has relied on such reports except where he is prepared to take full responsibility for the work of the other auditor. A reference to the work of another auditor is not considered to be a qualification of the report of the parent company auditor.

The Institute of Chartered Accountants in England and Wales in a statement issued in April 1965 is more explicit in fixing responsibility on the parent company's auditors where the consolidated accounts include subsidiary companies' accounts which have been audited by others. It provides that 'it is proper to take account of the nature and extent of any examination carried out by other external auditors . . . but whether the group accounts are prepared in the form of consolidated accounts or in some other form, the opinion which is expressed on them is the opinion of the auditors of the holding company'.

The Committee has concluded that it is appropriate at this time to recognize the trend toward considering the parent company auditor responsible and, therefore, recommends that Corporations Acts in Canada should include a provision along the lines of the proposed amendment to the Ontario Corporations Act as follows:

> Whether or not the assets and liabilities and income and expense of any one or more subsidiaries of a holding company are included in the financial statements of the holding company, the report of the auditor of the holding company may refer to the reports of auditors of one or more such subsidiaries but such reference shall not derogate from the duty of the auditor of the holding company to express an opinion on the financial statements.

The Committee would like to ensure that it is made clear that the foregoing recommendation should not be construed as a recommendation

which would require that the auditor of the parent company must also be the auditor of the subsidiary company or companies. The extent to which reliance can be placed by one auditor on the work or report of another auditor is a matter for individual professional judgment and in the Committee's view should not be the subject of legislation.

It is to be noted that the recommendation covers both consolidated and unconsolidated statements where there are subsidiaries with auditors different from that of the parent company."

Three observations must at once be made. The first and shortest is that, making due allowance for the fact that the quotation from the statement of April 1965 by the Institute of Chartered Accountants in England and Wales apparenly omits certain words, it does not appear to be noticeably explicit. For example the phrase, "but whether the group accounts are prepared in the form of consolidated accounts or in some other form, the opinion which is expressed on them is the opinion of the auditors of the holding company", does not say in as many words that the auditors of the holding company assume responsibility for the opinions of the other auditors, or that the expression of an opinion by the auditors of the holding company should exclude any reference to the work of other auditors, and thus by implication take all the responsibility on their own shoulders.

The Committee, however, leaves no doubt about the fact that it is recognizing "a trend toward considering the parent company auditor responsible", and proceeds to recommend that the Parliament of Canada should enact a provision similar to what is described as "the proposed amendment to the Ontario Corporations Act". It is, in fact, the proposed subsection 4 of section 158 of Bill 125, entitled "The Business Corporations Act, 1968", referred to at some length in Chapter XVI. Section 158 deals generally with the annual audit of a corporation, but does not otherwise deal with the conduct of auditors in relation to consolidated financial statements which are further provided for in section 167. The relevant portion reads:

"158. (1) The auditor shall make such examination as will enable him to report to the shareholders as required by subsection 2. R.S.O. 1960, c.71, s.82 (1).

(2) The auditor shall make a report to the shareholders on the financial statement, other than the part thereof that relates to the period referred to in subclause ii of clause b of subsection 1 of section 159, to be laid before the corporation at any annual meeting during his term of office and shall state in his report whether in his opinion the financial statement referred to therein presents fairly the financial position of the corporation and the results of its operations for the period under review in accordance with generally accepted accounting principles applied on

a basis consistent with that of the preceding period, if any. R.S.O. 1960, c.71, s.82(2); 1964, c.10, s.2; 1966, c.28, s.6(1) amended.

* * * * *

(4) Whether or not the assets and liabilities and income and expense of any one or more subsidiaries of a holding corporation are included in the financial statement of the holding corporation, the report of the auditor of the holding corporation required by subsection 2 may refer to the reports of auditors of one or more of such subsidiaries, but such reference shall not derogate from the duty of the auditor of the holding corporation to comply with subsection 2. *New.*"

With regard to this subsection, which the committee has espoused as a model, I am constrained to say, with the greatest respect, that it is far from explicit. In the first place, by using the words "but such reference shall not derogate from the duty of the auditor of the holding company to comply with subsection 2," it would not seem to contemplate a legitimate refusal of an auditor to express any opinion at all. Secondly, if it is intended, as I am advised is the case, to fix the auditor of the parent company—or "holding" company as the draftsman prefers to say—with responsibility for the work and opinions of the auditor of a subsidiary company where accounts are consolidated, it does not say so, and if it does not say so, it does not do so. The mountain has laboured and brought forth a mouse.

The third observation which the committee's report is bound to provoke arises from the sentence: "The extent to which reliance can be placed by one auditor on the work or report of another auditor is a matter for individual professional judgement and in the Committee's view should not be the subject of legislation." If it is a matter for professional judgement, it is also a matter for public concern. The word "reliance" should here be used in the sense of "adoption", and if the auditor of a parent company, using his professional judgement, concludes that he cannot rely on the work of another auditor in conducting an audit and expressing an opinion as to the fairness of the financial statements of a subsidiary company, he should undertake that work himself or decline the engagement.

If these publications are to be considered authoritative, as I think they must, they fall short of recommending a sufficient standard of care to be observed by the auditors of a parent company towards the work of other auditors engaged by that company's subsidiaries, particularly in the case of finance companies borrowing large sums from the public through the sale of obligations. I am in sympathy with the view of the Special Committee that the auditor of the parent company should not necessarily be the auditor of the subsidiary, and their emphasis upon the importance of trust among members of the profession; nor is it desirable that legislation be enacted where self-regulation will serve. Nevertheless,

if there is any lesson to be learned from the Atlantic disaster it is that the auditor of a parent company, in expressing an unqualified opinion on consolidated financial statements, must take full responsibility for the opinions of auditors of subsidiary companies, and that he should be liable, within the framework of the law of agency, for the consequences of their shortcomings. Two practical objections may be urged against this conclusion. Auditors are appointed by the shareholders, or, where a vacancy occurs between annual general meetings, by the board of directors of a company, and the auditor of a parent company may be confronted with a selection by its subsidiary company which, for one reason or another, may be or become unacceptable. In such a case it would not appear advisable to make an exception to the general rule which is proposed, since the primary auditor, in reporting on the consolidated financial statements, can make such qualifications as he considers necessary as to the extent of his reliance on other auditors, or, if he is placed in an intolerable position, refuse to express an opinion at all, giving his reasons. Then again if the laws of a foreign jurisdiction compel him to accept the opinion only of auditors licensed to practice there, and he is thereby debarred from making such tests of a secondary auditor's work as he considers necessary, he may, for all practical purposes, be compelled to accept that auditor's opinion on the accounts of a subsidiary company for the purposes of consolidation. This more serious difficulty would seem to yield to the same solution if the nature of it were fully disclosed in his report on the consolidated accounts. It is, of course, unlikely that companies will put up for long with a situation which produces even one qualified report for these reasons, much less a succession of them, and it will undoubtedly be said that recommendations of this type will hasten the disappearance of small accounting firms not associated with the large international practitioners, particularly in those parts of the country which have been spared the urban development of the last thirty years. If this be the result of their adoption, it is much to be regretted, but it is to be hoped that the accounting profession will be equal to any challenge which such a development presents. All professions have experienced and suffered to some extent from the tendency to centralize their activities in large centres of commerce and finance but, generally speaking, have managed to order their affairs according to the paramount requirements of the public interest.

# CHAPTER XVIII

## *Motives and Methods of C. P. Morgan*

Throughout the Commission's investigations evidence of the incompetence as well as the ingenuity of C. P. Morgan continued to accumulate. Although he had a marvellous capacity for keeping figures in his mind, and for expounding the details of complicated transactions with an ease which impressed and even mesmerized his auditors, he was a wretched administrator. This weakness may have been the result of a secretive quality which inhibited the maintenance of exact records and of a restless inventiveness which drove him to fresh enterprises, taken up with enthusiasm but seldom reduced to order. Whatever the reason, his neglect of the potentially prosperous business conducted from Oakville and his infatuation with promoters, as devoid of ability as they were of principle, must be considered fatal flaws in a character otherwise perfectly formed for deception on the grand scale. For a persuasive talker he was strangely inarticulate on paper and, as the record thus far shows, wrote seldom and mostly in his own hand. David Davidson testified that Morgan's infrequent typewritten correspondence was handled without difficulty by his own secretary, and as to his habit of keeping a few files on the window-sill behind his desk. For a man trained as a chartered accountant, and having some experience of the practice of that profession, he was unusually casual about records and reports, but his careful attention to the structure of financial statements as a means of facilitating the borrowing of money has been frequently referred to. Nevertheless, when Davidson brought his attention to the need for planning to provide information required by the Robert Morris Associates questionnaire, Morgan's response was that "these documents you throw out the window and go to work as if they don't exist",[1] and was

[1]Evidence Volume 79.

characteristic of his sense of responsibility to noteholders and shareholders and of the cynicism with which he viewed his responsibility to the public as president of a large finance company. Making every allowance for the fact that finance company business was highly competitive and that Altantic Acceptance was virtually a new comer to the field, which might justify acceptance of a type of risk and a quality of security which more conservative and established companies would reject, it seems clear that careful and conscientious application to the business of Atlantic Acceptance Corporation itself and Atlantic Finance Corporation could have improved this situation in the course of a decade; instead, as is all too readily apparent, Morgan, through his Adelaide Street subsidiaries recklessly advanced huge sums to enterprises and individuals whose worthlessness should have been manifest from the beginning. He seemed unable to let well enough alone, even though he had obtained through his own exertions impressive financial backing. His appetite for involvement in transactions in which his own interests usually were in conflict with those of his companies was insatiable, and must provoke wonder that there were sufficient hours in his day for him to develop them as far as he did. It is with his own personal interest, and the extent to which he nourished it in the five years before disaster overtook him, that this chapter must first be concerned.

### The Rise and Fall of a Fortune

Evidence as to Morgan's net worth at successive stages during the years 1960 to 1965 was presented by Mr. Wolfman on February 14 and 15, 1967.[1] In preparation for this testimony he examined all banking documents and brokerage records in the names of Morgan and his wife, including those produced by Mr. Maurice Clennent, assistant general manager of the Royal Bank of Canada, relating to an account maintained in that bank's branch at Freeport, Grand Bahama, under the name "Morgan Trust",[2] and all the Commission's documents relating to the net worth of private companies, the securities of which had no easily ascertainable market value, to determine the book value of Morgan's interest in them. Scarcely more than a week before Wolfman gave his evidence something in the nature of a windfall befell the Commission's records; Mr. Shepherd and Detective Smythe obtained permission from Mrs. Morgan to examine the premises at 11 St. Ives Crescent for documents illustrating her late husband's affairs. The word "windfall" is used advisedly, because the Commission had been assured by Morgan that he had turned over all his files and papers to the Clarkson Company, but a carton of papers was found which included cancelled cheques and other records, and which proved to be of considerable value in the attempt to

[1]Evidence Volumes 95-6.
[2]Exhibits 3347 and 3591.

present a picture of Morgan's finances, particularly as affected by trading in the shares of Analogue Controls Inc. and the payments to Frank Kaftel made necessary by that stock market manipulation.[3]

With the assistance of all these documents, and always subject to the existence of areas of investigation in Morgan's affairs which at the time defied the most patient inquiry and perhaps always will, Mr. Wolfman was able to determine the net worth of C. P. Morgan at four separate dates: March 24, 1960, September 6, 1961, August 31, 1962 and June 11, 1965, the fourth date being the last day of the week immediately preceding default of Atlantic Acceptance on the $5,000,000 note given to S.F.C.I. A fifth date was selected, July 2, 1965, or two weeks after default, to establish his net worth at a time when the effect of the default and its ramifications had been fully appreciated and had produced a catastrophic decline in his fortunes. The results of these calculations were summarized and tabulated as follows:[4]

C. POWELL MORGAN

ESTIMATED NET WORTH

| *Date* | *Documentation* | | *Net Worth* |
|---|---|---|---|
| March 24, 1960 | Statement of affairs submitted to the Toronto-Dominion Bank.............. | $277,928 | |
| | Less: Value of options not yet exercisable | 116,000 | |
| | | | $ 161,928 |
| September 6, 1961 | Statement of affairs submitted to the Toronto-Dominion Bank............. | 443,865 | |
| | Add: 1/3 interest in "Trio" assets described in statement of assets of Walton and Wagman at August 31, 1961......................... | 85,091 | |
| | | | $ 528,956 |
| August 31, 1962 | Statement of Affairs at September 6, 1961 | 443,865 | |
| | Add: 1/3 interest in net worth of "Trio" investments at August 31, 1962... | 254,452 | |
| | | | $ 698,317 |
| June 11, 1965 | Estimated net worth calculated for submission to the Royal Commission on Atlantic Acceptance........ | | $2,132,291 |
| July 2, 1965 | Estimated net worth calculated for submission to the Royal Commission on Atlantic Acceptance........ | | $ 32,485 |

It will be observed that the positions at March 24, 1960 and September 6, 1961 were derived from statements of affairs submitted to the Toronto-Dominion Bank in connection with applications for credit. The third date, August 31, 1962, was selected because it coincided with a statement of investments of C. P. Morgan, W. L. Walton and Harry Wagman,

[3]Exhibits 3809-74.
[4]Exhibit 3877.

heretofore referred to as the Trio, and the fourth and fifth dates for the reasons given above and for which estimates were made based on a variety of evidence which will be examined in due course.

All the papers relating to the applications for credit of C. P. Morgan, who kept his principal Toronto account at the 25 Adelaide Street West branch of the Toronto-Dominion Bank, were furnished to the Commission in the form of photostatic copies certified by the accountant of the branch.[5] Although on November 24, 1960 he represented himself as the owner of 418 preferred shares of Atlantic Acceptance at $16 per share and 19,000 common shares at $13 per share for a total value of $174,488, he had not by then exercised his option to the extent of owning that many common shares; in consequence a reduction of $116,000, representing the unoptioned shares, was made from the total of $277,928 shown as his net assets on the unsigned statement given to the bank, dated March 24, 1960,[6] and in the pencilled note in his own handwriting attached to it.[7] The circumstances under which this option came to be granted have been referred to in Chapter II[8] and were set out in a letter from Atlantic Acceptance Corporation dated August 18, 1958, addressed to him and signed by Norman F. Firth and Anthony C. Rooney as directors.[9] The number of shares involved and the time within which they were required to be bought by the optionee at $5.375 per share, are set out in the following extract from that letter:

| *"Time within which shares must be purchased* | *Number of shares which may be purchased* |
|---|---|
| (a) Prior to September 1, 1959 | none |
| (b) From September 1, 1959 to August 31, 1961 | 3,000 shares |
| (c) From September 1, 1960 to August 31, 1962 | 3,000 shares |
| (d) From September 1, 1961 to August 31, 1963 | 3,000 shares |
| (e) From September 1, 1962 to August 31, 1964 | 3,000 shares |
| (f) From September 1, 1963 to August 31, 1965 | 3,000 shares |
| | 15,000 shares" |

Other items shown among his assets were a house in Niagara Falls, Ontario, valued at $33,000 and mortgaged for $20,000; jewellery valued at $6,000; furs at $5,000; automobiles at $9,500; the cash surrender value of life insurance policies, $10,500; cash, $7,500; sundry stocks and bonds, $15,640; and receivables of $40,500. His liabilities were shown as a mortgage on the Niagara Falls residence of $20,000 and a loan from the Toronto-Dominion Bank outstanding at $4,400. On his pencilled

[5]Exhibit 3878.
[6]Exhibit 3878.1.
[7]Exhibit 3878.2.
[8]p. 53.
[9]Exhibit 22.

note included in the file Morgan showed as receivable $31,500 from John Belli Operations Limited, $9,000 from Mor-For Distributors in London, Ontario, and his hypothecated stocks included 15,000 shares of Arcan Corporation, valued at $6,000, and 200 common shares of Atlantic Acceptance at $2,600.

At this point it should be said that Morgan's widow, Mrs. Mildred L. Morgan, on reading in the press the report of this, and other evidence to be referred to later, which indicated that her late husband represented to the bank ownership of certain real estate of which she was the registered owner, instructed her solicitors, Messrs. Mitchell and Robinson of Toronto, to advise the Commission that she had been unaware of such representations, and in due course supplied an affidavit[10] which will be later reproduced in full.[11] Nothing however then occurred to disturb the progress of the successful president of Atlantic Acceptance Corporation, and the recommendation of the manager of the bank's branch at 25 Adelaide Street West was friendly and confident.

> "Mr. Morgan's loans fluctuate quite widely during the year and he is requesting an addition in his credit as indicated above to assist him in the purchase of a new home in Lawrence Park, the transactions on which are being completed on April 15, 1960. The increased loan will be of a temporary nature only, as he has sold his own home in Niagara Falls, and this transaction closes on the same date. While, therefore, the increased credit will be of a temporary nature we are applying for the increased amount for the full year.
>
> There is no concern here whatsoever, in our opinion, and we are quite sure that Mr. Morgan's loans will fluctuate widely as they did during the past year.
>
> We have come to know Mr. Morgan very well during the past year, and regard him very highly. His companies continue to expand very rapidly and our portion of the business here grows in importance.
>
> Recommended."

The next application for credit to the Toronto-Dominion Bank was for $45,000, made on February 20, 1961,[12] to replace the $30,000 allowed the previous year which expired on March 31. By this time Morgan's securities pledged with the bank included 2,000 shares of Atlantic Acceptance common shares with a market value of $17 each, 10,000 shares of Dominion Leaseholds Limited and "demand notes dated April 25/60 signed by Lucinda Morgan payable to C. P. Morgan and endorsed" for $36,500. On this application a new manager at 25 Adelaide Street West, Mr. D. A. Moss, informed the head office of a forthcoming

[10] Exhibit 4912.
[11] p. 1470.
[12] Exhibit 3878.4.

event, which has been dealt with at some length in Chapter V, in the following terms:

> "We have advanced $25,000 to Mr. Morgan to enable him to purchase a $25,000 Commodore Sales Debenture 6%/75 on a 60 day basis. We are given to understand that this company is associated with Atlantic and this debenture will be taken up by A.A.C. within 60 days."

The next net worth statement found in the bank's records, was dated September 6, 1961[13] and provided one of the elements of Wolfman's calculation of Morgan's net worth on that date. On this occasion Morgan told the bank that it amounted to $443,865. The principal changes in the situation shown eighteen months before are his inclusion of a house, described as being in his wife's name, and valued at $75,000 with no encumbrances—this was the house at 11 St. Ives Crescent in Toronto recently purchased for $49,000—and 8,000 common shares of Atlantic Acceptance valued at $185,000, which represented a more reasonable calculation of his holdings of those securities than previously given. The receivable from Mrs. Morgan was, at this point, valued at $15,000, and securities valued at $130,000 were shown as lodged with the Toronto-Dominion Bank and did not vary in any material way from those shown as pledged in the previous February. The difference between the net worth reported to the bank and the amount of $528,956 shown in the summary reproduced above is the inclusion of the sum of $85,091 as the value attributed to Morgan's one-third interest in the assets of the Trio, described in the statement drawn in Walton's handwriting and dated August 31, 1961 entitled "W.L.W. and H.W.—Statement of Assets and Liabilities as at August 31/61",[14] which was not reported to the bank.

The position at August 31, 1962 was calculated in much the same way. For the type of assets reported to the bank the statement of affairs as at September 6, 1961, the last such statement signed by Morgan to be found, was again resorted to. Wolfman found by comparing this statement to an application for credit to the Toronto-Dominion Bank dated April 2, 1963, to which a list of Morgan's securities held as collateral by the bank was attached, that their value had not declined in the interim although their volume had been augmented; therefore valuation as at September 6, 1961 would not be too high at August 31, 1962, the date of the second statement of investments of the Trio, which was on this occasion prepared with the heading "C. P. Morgan, William L. Walton and H. Wagman", and showed on its face a division of the total assets into three parts with Morgan's share at $254,452.05. Once again this asset was not reported to the bank and, when added to the net worth re-

[13]Exhibit 3878.3.
[14]Exhibit 860.

ported at September 6, 1961, produced a total of $698,317 for August 31, 1962.

The increase in Morgan's net worth between March 24, 1960 and September 6, 1961, amounting to some $367,000, cannot be fully accounted for, but some of the accretions can be identified. From 1958 up to and including the six-month period ended June 30, 1965 the record of Morgan's remuneration from Atlantic Acceptance Corporation, consisting of salary, profit-sharing through bonuses and his net gains at the dates of his exercising his option to purchase Atlantic shares, is as follows:[15]

ATLANTIC ACCEPTANCE CORPORATION LIMITED
REMUNERATION PAID TO C. POWELL MORGAN

| | *1958* | *1959* | *1960* | *1961* | *1962* | *1963* | *1964* | *6 months ended June 30, 1965* |
|---|---|---|---|---|---|---|---|---|
| Salary | $12,133.32 | $24,999.96 | $24,999.96 | $24,999.96 | $30,000.00 | $30,000.00 | $30,000.00 | $20,000.00 |
| Profit sharing | | | | | | | | |
| March | Nil | Nil | 3,020.00 | 5,100.00 | 6,783.00 | 10,000.00 | 10,000.00 | 19,000.00 |
| December | Nil | Nil | 1,145.00 | 1,145.00 | 1,375.00 | 1,375.00 | | |
| Total paid during the year | $12,133.32 | $24,999.96 | $29,164.96 | $31,244.96 | $38,158.00 | $41,375.00 | $40,000.00 | $39,000.00 |
| Stock Options | | | | | | | | |
| Value at exercise date | | | $40,500.00 | $114,750.00 | $60,000.00 | $51,000.00 | | |
| Cost at $5.375 per share | | | 16,125.00 | 32,250.00 | 16,125.00 | 16,125.00 | | |
| Net gain at exercise date | | | $24,375.00 | $82,500.00 | $43,875.00 | $34,875.00 | | |

It will be noted that between March 24, 1960 and September 6, 1961 he exercised three options to purchase Atlantic common shares to the number of 3,000 in each case. The price was $5.375 per share and the options, which could be exercised at any time prior to August 31 in each year, were taken up before August 31, 1960, again before August 31, 1961 and just after that date in the same year. Throughout this period of eighteen months Morgan actively traded in Atlantic stock, selling 6,000 common shares for a cash profit in the order of $107,000. Since these shares rose in price during the period by about $5.50 per share, a further gain of $20,000 or so would have accrued. He also received $2,500 in cash from a division of profits made on the consolidation of the debts of John Belli Operations Limited, described in Chapter VI,[16] and an additional amount of $2,000 in cash, evidently from Nevil Plastics Inc., in March 1960. There is no explanation for the latter payment, but it was the subject of correspondence between W. R. Collier, manager of the Toronto-Dominion Bank's branch at 25 Adelaide Street West, and the Manufacturers' and Traders' Trust Company of Buffalo, N.Y. Collier's letter was dated March 16, 1960 and asked the Buffalo bank to certify cheque No. 1121 of Nevil Plastics Inc. dated March 12. Attached to this

[15]Exhibit 3883.
[16]pp. 193-4.

is a handwritten note in Morgan's writing, also dated March 16, in the following terms:

> "Russ—
>
> Would you have the attached cheque forwarded to Buffalo for certification and return to me. Barry McFadden started this morning. Thanks
>
> Powell"

The original of this letter in the bank's files contains a handwritten notation indicating that the certified cheque was delivered on March 21.[17] In addition to this payment, $10,700 was paid out to Morgan from the Trio account at the Guaranty Trust Company, according to the evidence of its passbook,[18] in two amounts, the first of $2,500 on June 13 and the second of $8,200 on June 22. If his salary is left out of account as a possible source of gain because it was not noticeably high at this stage, $227,000 out of the increase of $367,000 can be accounted for, and an additional source of increase may have been the house at 11 St. Ives Crescent, which was bought on April 15, 1960 for $49,000 and which Morgan valued in his statement of affairs for September 6, 1961 at $75,000. Nevertheless $100,000 of the increase cannot be accounted for in connection with any of the transactions referred to, or derived from his very active brokerage accounts, and it is unlikely to be attributable wholly to race-track betting.

Mr. Wolfman's far-ranging inquiries into the origin of C. P. Morgan's fortune were summarized in the schedule appearing opposite which shows the approximate date and description of transactions which resulted in cash gains made by him between March 1960 and May 1965, together with comments as to the apparent disposition of their proceeds.[19] All of the known major cash gains paid into Morgan's bank or brokerage accounts for his own use, or at his direction, have been listed, and all these were the subject of testimony given to the Commission, but the countless transactions between companies which he influenced or controlled were not taken into account except as they actually produced cash in his hands. It has been seen on the schedule of net worth[20] that between September 6, 1961 and August 31, 1962 the whole increase was to be accounted for by the value of Morgan's one-third interest in the Trio investment account, and this in itself is attributable to the value of the Dale Estate shares which the Trio held during that interval, together with the appreciation in value of 63,000 shares of Commodore Business Machines and a profit made on the sale of Aurora Leasing Corporation notes.

The fourth and fifth dates selected for the estimates of C. P. Morgan's net worth, at its peak and at its lowest point, require, at least in the

[17] Exhibit 3878.6.
[18] Exhibit 807.
[19] Exhibit 3886.
[20] p. 1455.

## Source and Disposition of Known Major Cash Gains Related to Atlantic Acceptance Corporation
## (Received in Canada and in Morgan Trust Account—Freeport)

| Approximate Transaction Date | Description of Transaction | Estimated Gross Cash Gain | Estimated Net Cash Gain By C. P. Morgan | Apparent Disposition of Total Proceeds |
|---|---|---|---|---|
| March, 1960 | Payment by Nevil Plastics Inc. reason unexplained | $ 2,000 | $ 2,000 | Paid to C. P. Morgan |
| June, 1960 | Consolidation of the Debts of John Belli Operations Limited | 7,500 | 2,500 | $2,500 was paid to C. P. Morgan and the balance retained in the "Trio" Account at the Guaranty Trust Company. |
| December, 1960 | Sale of Aurora Leasing Notes by Walton, Wagman and Morgan | 97,272 | 39,090 | $10,000 paid to C. P. Morgan and the balance paid into the "Trio" Account at Guaranty Trust. This sum and others were disbursed in the following manner up to May, 1961:<br>$15,000 to Calcutta Holdings for 30,000 Dominion Leasehold Common Shares,<br>$23,000 to N. G. K. Investments for subscription to N. G. K. Common Stock,<br>$10,250 for the purchase of 10,000 Arcan Common Shares,<br>$25,000 invested in Common Shares of Aurora Leasing Corporation,<br>$15,000 invested in Shares of Frederick's Department Store Limited,<br>$2,000 paid to Oceanic Investments Limited,<br>$7,500 paid to Hilltop Holdings Limited. |
| May, 1961 | Sale of Commodore Sales Acceptance Minority Interest | 22,500 | 22,500 | Disposition of proceeds was through C. P. Morgan's Account at Netherlands Overseas Trading Corp. |
| October, 1961 | Oceanic Investments sale of Dale Estate Shares | 135,000 | 45,000 | $60,000 advanced on Directors' Loan to Yarrum Investments; $25,000 paid to C. P. Morgan for 25,000 Arcan Common; $10,000 paid to Barrett Goodfellow for 10,000 Arcan Common; $18,000 paid to C.I.B.C. re Bank Loans; $6,000 invested in 3,000 Shares of Frederick's. |
| February, 1962 | Sale of Land and Buildings to Valley Farm and Enterprises Limited | 196,400 | 65,467 | Proceeds received as Directors' Loans and drawn down in the following manner:<br>$9 invested in 100% of Valley Farm Common Shares,<br>$52,247 to repay a "Trio" Loan at the Canadian Imperial Bank of Commerce,<br>$75,000 paid into C. P. Morgan's Bank Account,<br>$35,000 paid to Barrett, Goodfellow & Company for the Account of Walter Pahn (a nominee for C. P. Morgan). |
| March, 1962 | Sale of Crest Acceptance Shares to Atlantic Acceptance Corporation | 16,000 | 5,333 | $10,000 invested in 10,000 Arcan Common Shares, balance paid to N. G. K. Investments. |
| July, 1962 | Profit on transfer of John Belli Shares to Chartered Management | 3,227 | 3,227 | Proceeds paid to C. P. Morgan |
| July, 1962 | Payments by N Levinson reason unexplained | 40,000 | 40,000 | Remitted to C. P. Morgan's Account at Annett's, used to buy 1,000 A.A.C. for $18,050, the balance paid to C. P. Morgan and later used to purchase 3,000 A.A.C. under option for $16,125. |
| April, 1963 | Sale of Land to Treasure Island Properties Limited | 85,000 | 42,500 | Proceeds received by D. W. Reid and invested in a Note of Frederick's Department Store which was registered in the name of Marco Holdings. According to D. W. Reid's testimony, 50% of this Note was held for N. G. K. Investments Ltd. Mr. Morgan's testimony indicates that 50% of the Note was to accrue to himself personally. |
| July, 1963 | Sale of Shares in John Belli Operations Limited | 34,642 | 11,547 | $28,000 advanced as Directors' Loan to Dallas Holdings and later invested in Aurora Leasing; $6,642 retained in C. P. Morgan's Bank Account. |
| July, 1963 | Sale of Dale Estate Shares by "Trio" | 160,000 | 53,333 | $100,000 loaned to Jacroy Canada Limited and Note taken by H. Wagman in trust. $50,000 loaned to Masco Construction. |
| July, 1963-June 17, 1965 | Sale of Commodore Business Machines Common Shares | 372,008 | — | All cash profits apparently paid to Kaftel as commission for the sales of Shares. In addition to the cash profits, at June 11, 1965, C. P. Morgan held 81,286 Shares at a market value of over $400,000—these were subsequently sold out to cover Loans at a much lower price. |
| October, 1961-May, 1965 | Sale of Analogue Controls Common Shares | 761,429 | 371,721 | Approximately $389,708 paid to Kaftel as share of profits, balance disbursed out of Freeport Bank Account by C. P. Morgan, as per the attached schedule of the Morgan Trust Account. |
| October, 1964-May, 1965 | Trade of Analogue Controls Common Shares for Stock of Cimcony | — | — | Received $30,000 of Cimcony Limited Preferred Shares for 75,000 Analogue Shares. |
| | Total Major Cash Gains | | $704,218 | |

case of June 11, 1965, more copious illustration. This is supplied by a schedule setting out the different categories of his assets at June 11, 1965 and the value attributed to each, his liabilities at the same date and an estimated net worth of $2,132,291; there follows a calculation of his net worth at July 2, expressed as estimated at June 11, less the decline in the market value of his list of securities and of the value of securities held in private companies due to their insolvency, and produces a net worth of only $32,485.[21]

C. POWELL MORGAN
ESTIMATED NET WORTH*
VALUED AT JUNE 11, 1965

| | | |
|---|---|---|
| Assets | | |
| Cash at banks | | $ 73,355 |
| Securities lodged as collateral: | | |
| (at market value) | | |
| At banks | $ 688,491 | |
| At British Mortgage & Trust Co. | 971,163 | |
| At Angusdale Limited | 190,000 | |
| | $1,849,654 | |
| On margin accounts at Brokers | 1,054,946 | |
| | | 2,904,600 |
| Privately held securities: | | |
| Unlisted securities—at book value | | 345,474 |
| 39 Shares of Atlantic Acceptance Corporation Limited | | 790 |
| Shares of Analogue Controls Inc.—de-listed (22,700 shares) | | — |
| 127,410 escrowed shares of Lucayan Beach Hotel and Development Limited (valued at 60¢ per share) | | 76,446 |
| Advances to Associated Companies | | 364,149 |
| Other assets—per statement of assets submitted to the Toronto-Dominion Bank (including house, cars and interest in Mortgage at approximate values) | | 115,000 |
| Total assets | | 3,879,814 |
| Less: Liabilities | | |
| Bank loans Payable | $ 440,140 | |
| Loan of British Mortgage & Trust Co. | 650,000 | |
| Loan of Angusdale Ltd | 117,000 | |
| Due to Brokers | 495,705 | |
| Advances from Private Companies | 44,678 | |
| | | 1,747,523 |
| Estimated net worth at June 11, 1965 | | 2,132,291 |

ESTIMATED NET WORTH AT JULY 2, 1965

| | | |
|---|---|---|
| Net worth at June 11, 1965 | | $2,132,291 |
| Less: Decline in market value of listed securities | $1,636,708 | |
| Decline in value of securities of private companies due to insolvency | 463,098 | |
| | | 2,099,806 |
| Estimated net worth at July 2, 1965 | | $ 32,485 |

*This schedule includes C. P. Morgan's repayments on the E. D. Sassoon bank loan which appear to total $32,359.45 and which were recovered by Mrs. Mildred L. Morgan when the collateral (1,250,000 shares of The Lucayan Beach Hotel and Development Limited) was sold to the Receiver following June 17, 1965. In addition 55,000 shares of Tamarind Developments Limited, a Bahamas land company, are also included. This is according to an affidavit of Mrs. Mildred L. Morgan sworn on June 30, 1967. Additional funds in excess of $100,000 which may have been diverted through Bahamas bank accounts are not included in this schedule.

[21]Exhibit 3887.

The concluding note requires the general observation that this schedule, and the ten supporting schedules which accompany it,[22] treat Morgan's assets and liabilities as including those of his wife, and comprise the value of all assets situated in Canada or the United States concerning which evidence has been given before the Commission, or about which Mr. Wolfman learned by other means. In addition the amount which stood to his credit in the Morgan Trust account at the Royal Bank of Canada branch in Freeport, Grand Bahama, and the advances made by him to L.B.H. Management Limited, the Bahamian company which was incorporated to supplant Allen Manus in the management of the Lucayan Beach Hotel and its ancillary properties, have been included as assets, and to his liabilities has been added $242,640 representing the estimated amount of his debt to the E. D. Sassoon Banking Company in Nassau. Some further observations must be made on the liquidation of this debt subsequent to the selected dates.

Bank accounts in the name of C. P. Morgan or C. P. and Mildred Morgan, including two Trio accounts and the Morgan trust account in Freeport, had at June 17, 1965 credit balances as follows:

| | |
|---|---|
| Bank of Nova Scotia<br>44 King Street West,<br>Toronto, Ontario | $3,248.60 |
| British Mortgage and Trust Company,<br>2200 Yonge Street,<br>Toronto, Ontario.<br>C. P. and Mildred Morgan | 122.50 |
| Canadian Imperial Bank of Commerce,<br>25 King Street West,<br>Toronto, Ontario | 153.83 |
| Canadian Imperial Bank of Commerce,<br>25 King Street West,<br>Toronto, Ontario.<br>Walton, Wagman and Morgan | — |
| Canadian Imperial Bank of Commerce,<br>Eglinton and Bayview Avenues,<br>Toronto, Ontario | 453.89 |

[22]Exhibit 3887.

| | |
|---|---|
| Guaranty Trust Company—"Trio Account",<br>366 Bay Street,<br>Toronto, Ontario. | — |
| Royal Bank of Canada—Morgan Trust,<br>Freeport,<br>Grand Bahama. | 63,603.12 |
| Toronto-Dominion Bank,<br>25 Adelaide Street West,<br>Toronto, Ontario | 427.67 |
| Toronto-Dominion Bank,<br>Yonge Street and Lawrence Avenue,<br>Toronto, Ontario.<br>C. P. Morgan and Mildred Morgan | 5,345.63 |
| | $73,355.24 |

It will be seen that two accounts in which Morgan had a third interest together with Walton and Wagman had been completely disbursed, and that the substance of the total credit balance of $73,355.24 consisted of $63,603.12 in the Morgan Trust account at Freeport. A schedule of securities pledged with banks, British Mortgage & Trust Company at Stratford and Angusdale Limited, a personal investment firm of which James E. McConnell, a director of Great Northern Capital Corporation and briefly of Atlantic Acceptance before its collapse, was the principal, with quoted market prices at June 11 and July 2 and values at the same dates, is displayed opposite followed by a similar schedule showing securities held by brokers.[23] Morgan owned, to the nearest thousand dollars, public securities with a value of $2,904,000 which were principally those of Commodore Business Machines in excess of $2,000,000 and of Atlantic Acceptance just under $500,000. The shares of Lucayan Beach Hotel Company, or Lucayan Beach Hotel and Development as it was latterly called, which Morgan acquired to the number of 25,000 by assuming in March 1964 a debt of $250,000 owed by Freeport International to the E. D. Sassoon Banking Company of Nassau, are valued at $1.10 per share, in spite of the existence of an unlisted market for them, since this was what the Montreal Trust Company paid to the Sassoon Bank after the collapse and indeed represented Morgan's cost of acquisition plus accrued interest; these subsequently became 1,250,000 new shares after the stock was split.

[23]Exhibit 3887.

# C. POWELL MORGAN

## Securities Held by Banks and Others
## Listed at June 17, 1965
## Valued at Market Prices—June 11 and July 2, 1965

| *Security* | *E. D. Sassoon's Bank* | *Toronto-Dominion 25 Adelaide St. Toronto* | *Canadian Imperial Bank of Commerce 25 King St. W. Toronto* | *Bank of Nova Scotia-King and Bay-Tor.* | *British Mortgage & Trust Stratford* | *Angusdale Ltd.* | *Total Securities Held* | *Market Quotation* | | *Total Value of Holdings* | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | *June 11, 1965* | *July 2, 1965* | *June 11, 1965* | *July 2, 1965* |
| Atlantic Acceptance Corporation Limited | | | | | | | | | | | |
| Common | | 3,000 | 3,000 | | 18,000 | | 24,000 | $ 20.25 | $ 5.62 | $486,000 | $134,880 |
| 1st Preferred | | 18 | | | | | 18 | 20.62½ | 10.75 | 371 | 194 |
| Commodore Business Machines (Canada) Limited | | | | | | | | | | | |
| Common | | 4,500 | 2,100 | | 37,944 | | 44,544 | 7.62½ | 2.85 | 339,648 | 126,950 |
| Warrants | | 6,800 | | | | | 6,800 | 4.25 | 1.50 | 28,900 | 10,200 |
| R. C. Allen Business Machines Limited | | | | | | | | | | | |
| Common | | 700 | | | | | 700 | 5.75 | 5.75 | 4,025 | 4,025 |
| Dominion Leaseholds Limited | | | | | | | | | | | |
| Common | | 96,500 | | | | | 96,500 | .24 | .15 | 23,160 | 14,475 |
| Arcan Corporation Limited | | | | | | | | | | | |
| Common | | 5,500 | | | | | 5,500 | .10 | .10 | 550 | 550 |
| General Spray Service Inc. | | | | | | | | | | | |
| Common | | 500 | | | | | 500 | — | — | — | — |
| Warrants | | 500 | | | | | 500 | — | — | — | — |
| Calvert-Dale Estates Limited | | | | | | | | | | | |
| Warrants | | 17,000 | | | | | 17,000 | — | — | — | — |
| Commodore Business Machines (Canada) Limited | | | | | | | | | | | |
| Series A Debentures | | $55,000 | | $40,000 | | $100,000 | $195,000 | 190.00* | 70.00 | 370,500 | 136,500 |
| Series B Debentures | | | | | $180,000 | | $180,000 | 152.00† | 70.00 | 273,600 | 126,000 |
| Western Heritage Properties Limited | | | | | | | | | | | |
| Debentures | | $ 1,200 | | | | | $ 1,200 | 100.00 | — | 1,200 | 1,200 |
| Trans Video Productions Limited | | | | | | | | | | | |
| Debentures | | $ 3,000 | | | | | $ 3,000 | — | — | — | — |
| Common | | 300 | | | | | 300 | — | — | — | — |
| Selectra Industries Limited | | | | | | | | | | | |
| Common | | 50 | | | | | 50 | — | — | — | — |
| White Electronic Developments Limited | | | | | | | | | | | |
| Common | | 2,500 | | | | | 2,500 | .10 | .10 | 250 | 250 |
| Plains Petroleum Limited | | 15,000 | | | | | 15,000 | .18 | .17 | 2,700 | 2,550 |
| Analogue Controls Inc. | | | | | | | | | | | |
| Common | | | | | 25,000 | | 25,000 | — | — | — | — |
| Five Wheels Limited | | | | | 35,000 | | 35,000 | 1.25 | 1.00 | 43,750 | 35,000 |
| Lucayan Beach Hotel and Development Limited | 1,250,000 | | | | | | 1,250,000 | | | 275,000 | 275,000 |
| | | | | | | | | | | $1,849,654 | $867,774 |

*Series A Debentures are convertible at $4 per Share — the market value used in the absence of a June 11, 1965 quote was therefore 25 Shares per Debenture at $7⅝ per Share, or $190.
†Series B are convertible at $5 per Share versus $4 for Series A — Value is therefore 80% of Series A market value.

## C. POWELL MORGAN

### Securities Held by Brokers
### Listed at June 17, 1965
### Valued at Market Prices—June 11 and July 2, 1965

| Security | Jenkin, Evans | Barrett, Goodfellow | Annett Partners | O'Brien, Williams | Total Securities Held | Market Quotation | | Value of Total Holdings at Market Price | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | June 11, 1965 | July 2, 1965 | June 11, 1965 | July 2, 1965 |
| Atlantic Acceptance Corporation Limited — Common | | (160) | | | (160) | $ 20.25 | $ 5.62 | ($ 3,240) | ($ 899) |
| Commodore Business Machines (Canada) Limited | | | | | | | | | |
| — Common | 5,775 | 24,168 | 900 | 6,099 | 36,942 | 7.62½ | 2.85 | 281,683 | 105,285 |
| — Warrants | | 29,200 | 11,300 | | 40,500 | 4.25 | 1.50 | 172,125 | 60,750 |
| — Series A Debentures | | 210,000<br>$41,000 | $44,000 | | $295,000 | 190.00 | 70.00 | 560,500 | 206,500 |
| Arcan Corporation Limited — Common | | 23,283 | 300 | | 23,583 | .10 | .10 | 2,358 | 2,358 |
| Dominion Leaseholds Limited — Common | | 116,000 | | 46,000 | 162,000 | .24 | .15 | 38,880 | 24,300 |
| Five Wheels Limited | | 500 | | | 500 | 1.25 | 1.00 | 625 | 500 |
| Plains Petroleums Limited — Common | | 10,500 | | | 10,500 | .18 | .17 | 1,890 | 1,785 |
| Maralgo Mines Limited — Common | | 1,000 | | | 1,000 | .12½ | .11 | 125 | 110 |
| General Spray Service Inc. — Units | | | 500 | | 500 | — | — | — | — |
| — Warrants | | | 300 | | 300 | — | — | — | — |
| Sussman Realty Corporation — Warrants | | | 1,000 | | 1,000 | — | — | — | — |
| | | | | | | | | $1,054,946 | $400,689 |

Morgan held unlisted securities at a book value of $345,474. The cost, where known, and the book value according to the most recent financial statements of the issuing companies are as follows:

C. POWELL MORGAN
SHARE HOLDINGS IN UNLISTED COMPANIES
AT JUNE 17, 1965

| | Cost (*if known*) | *Book Value per most recent financial statements* |
|---|---|---|
| American Automation (Canada) Limited (30 common shares) | n/a | |
| Associated Canadian Holdings Limited (67,837 common, 33,618 preferred) | Nominal) amount) | $206,657 |
| Aurora Leasing Corporation Limited (6,800 common shares) | | 22,630 |
| Canada Motor Products Limited (1/3 interest) | $ 6,667 | — |
| Chartered Management Consultants Limited (1/3 interest) | 33 | 5,074 |
| Conarm Developments Limited (30% interest) | 1,500 | — |
| Dalite Corporation (Canada) Limited (25% interest) | — | 37,508 |
| Dallas Holdings Limited (1/3 interest) | 1 | — |
| D.H.I. Limited—contingent interest in equity | — | — |
| Fun-A-Marin Limited (40% interest) | 15,000 | — |
| Frederick's Department Store Limited (10,000 common shares) | 10,000 | — |
| General Lawn Spray Limited (300 common shares) | 300 | — |
| Hebard Holdings Limited (100% interest) | 3 | — |
| Hilltop Holdings Limited (1/3 interest) | 2,500 | 1,611 |
| London Lighthouse Investments Limited (100% interest) | 1 | — |
| M.L.B. Investments Limited | n/a | 12,676 |
| Manhattan Sound Corporation Inc. (30 shares) | 30,000 | — |
| Marco Holdings Limited (50% interest) | 1 | 1,821 |
| Masco Construction Company Limited (100% interest) | 3 | — |
| Motion Picture Security Corporation (20 shares) | n/a | — |
| Mortgage Trust & Savings Corporation (Bahamas) Limited (100% interest including 25% interest in Cimcony Limited, acquired in exchange for Analogue Control shares; financial statements are not available) | — | n/a |
| N.G.K. Investments Limited (700 shares) | 140 | 7,554 |
| Symphony Paint Company (3,079 shares out of 3,310 issued—held by C. M. Solomon) | — | — |
| Tamarind Developments Limited (55,000 shares) | n/a | Est. 41,500 |
| Treasure Island Complex (extent of interest unknown) | n/a | n/a |
| Valley Farm & Enterprises Limited (1/3 interest) | 3 | — |
| Westworld Artists Productions Inc. (interest unknown) | n/a | n/a |
| Yarrum Investments Limited (1/3 interest) | 1 | 8,443 |
| Total book value | | $345,474* |

n/a—Not available

*It is estimated that, following the collapse of Atlantic Acceptance, only the shares of Chartered Management Consultants, M.L.B. Investments and Tamarind Developments continued to show a book value as set out above. The decline in book value of the total shareholdings in unlisted companies is estimated at $286,224.

It will be seen that the results of this calculation are somewhat fragmentary and the estimate may be regarded as conservative. Subsidiaries of the companies shown, or of companies related to them, have not been listed, since the securities of those that have been account for the whole book value of the investment in so far as it can be ascertained. In the case of Associated Canadian Holdings the cost of its shares is shown as a "nominal amount", because they were issued to Morgan in exchange for shares

of Commodore Business Machines which, after sales to Don Mills and others as described in Chapter VIII, cost him nothing. Also, because there are no financial statements available for Mortgage Trust & Savings Corporation (Bahamas) Limited or for Cimcony Limited, no value has been shown for Morgan's 100% interest in the former which included a 25% interest in the latter, purchased for 75,000 shares of Analogue Controls, which themselves were difficult to value because they had been de-listed by the Toronto Stock Exchange in May 1965. The same lack of financial information precluded an estimate in the case of the Treasure Island group of companies, but in any event at July 11 there was no value to the equity in any of them; it also applies to the shares in Manhattan Sound Corporation owned by Morgan and his wife, and those of Symphony Paint Company held by Carl M. Solomon in trust, since the equity in both these companies was so impaired as to leave no book value for the share capital whatsoever, according to the latest financial statements.

The summary of Morgan's net worth shows loans totalling $364,-149, made by him or in which he had an interest, to a number of the companies, not listed on any exchange, which appear in the last schedule reproduced. These were outstanding as follows at June 11:

| | |
|---|---|
| Associated Canadian Holdings Limited | $24,000 |
| Aurora Leasing Corporation Limited | 2,000 |
| Gassem Enterprises Limited | 7,500 |
| Dallas Holdings Limited—C. P. Morgan | 4,125 |
| —H. Wagman and C. P. Morgan | 600 |
| Frederick's Department Store Limited— note to Marco Holdings—50% interest | 42,500 |
| Fun-A-Marin Limited | 1,500 |
| General Lawn Spray Limited | 43,000 |
| General Spray Service Inc.—debentures | 30,000 |
| Jacroy Canada Limited—$100,000, ⅓ interest | 33,333 |
| L.B.H. Management Company Limited | 127,207 |
| Masco Construction Limited (⅓ interest in $100,000 advance) | 33,334 |
| N.G.K. Investments Limited | 2,000 |
| Treasure Island Properties Limited | 3,000 |
| Valley Farm and Enterprises Limited—Directors' loan, (⅓ interest in $18,820) | 6,270 |
| Yarrum Investments Limited (⅓ interest in $11,340) | 3,780 |
| | $364,149 |

The most considerable of these loans is that made to L. B. H. Management in the amount of $127,207 which was advanced from the Morgan Trust account in the Royal Bank of Canada at Freeport. The other assets of $115,000 included the house at 11 St. Ives Crescent, an automobile and household goods, regardless of whether they belonged to Mrs. Morgan as she asserts, at least in the case of the house. The ascertained and estimated value of all these assets at June 11, 1965, before deducting liabilities, was roughly $3,878,927.

On the liabilities side were the following loans payable to four different banks as follows:

| | |
|---|---|
| Toronto-Dominion Bank<br>25 Adelaide Street West, Toronto | $115,000 |
| E. D. Sassoon Banking Co. Limited<br>Nassau, Bahamas | 242,640 |
| Canadian Imperial Bank of Commerce<br>25 King Street West, Toronto | 32,500 |
| Bank of Nova Scotia,<br>44 King Street West, Toronto | 50,000 |
| | $440,140 |

There were also at June 17, 1965 three loans owing to British Mortgage & Trust Company, amounting in the aggregate to $650,000, with securities of the following companies pledged.

| *Collateral* | | *Amount of Loan* |
|---|---|---|
| Commodore Business Machines | 16,000 shares | |
| Five Wheels Limited | 35,000 shares | |
| Analogue Controls Incorporated | 25,000 shares | $200,000 |
| Atlantic Acceptance Corporation | 18,000 common | 250,000 |
| Commodore Business Machines | $18,000 debentures<br>4,000 shares | |
| Associated Canadian Holdings Ltd. | ⅖ of 42,725 Commodore Business Machine shares | 200,000 |
| | | $650,000 |

There was also a loan to Morgan from Angusdale Limited, outstanding at June 17 in the amount of $117,000, the collateral security pledged being $100,000 of the Series A debentures of Commodore Business Machines. The brokerage accounts of C. P. Morgan consisted of three at Barrett, Goodfellow & Co., a number 1 and a number 2 account, another in the name of Walter Pahn who was his nominee, two accounts, one for transactions in Canadian funds and the other in those of the United States, at Annett Partners, and one account at each of Jenkin, Evans & Co., John

R. A. Daly & Co.

Frame & Co., Merrill, Lynch, Pierce, Fenner & Smith, ~~R. A. Daley & Co.~~ and O'Brien, Williams & Co.; there were two in the name of Mildred Morgan, one at Barrett, Goodfellow & Co. and the other at Annett Partners. Liabilities to the brokers in respect of these accounts were as follows:

| | |
|---|---|
| Annett Partners Limited | |
| C. P. Morgan—Canadian dollar account | $ 53,360.12 |
| —U.S. dollar account | 317.09 |
| Barrett, Goodfellow & Co. Limited | |
| C. P. Morgan #1 account | 173,916.92 |
| Walter Pahn (nominee account) | 247,539.28 |
| Jenkin, Evans & Co. Limited | |
| C. P. Morgan | 12,307.25 |
| O'Brien, Williams & Co. Limited | |
| C. P. Morgan | 8,264.70 |
| | $495,705.36 |

In addition to these debts Morgan was evidently liable for a third of the money owing by himself, Tramiel and Kapp as Don Mills to Aurora Leasing Corporation which had been outstanding for three years, and in his case amounted to $24,678; Mrs. Morgan owed Motion Picture Security Corporation in New York $20,000, collaterally secured by her shares in Manhattan Sound Corporation. The sum of all these liabilities was $1,747,523 shown on the schedule of estimated net worth.

### Mrs. Morgan's Affidavit

At the time when this evidence was given it comprehended all the known assets and liabilities in Canada, the United States and elsewhere, less such amounts as may have been paid to the Sassoon Bank in Nassau to reduce the principal amount of the loan of $250,000 which Morgan had assumed. At this point Mrs. Morgan's affidavit of June 30, 1967, with its account of the growth of her own assets and the attached schedule of them, and her liabilities at June 18, 1965, should be seen in full.[1]

IN THE MATTER OF THE ROYAL COMMISSION ON ATLANTIC ACCEPTANCE CORPORATION LIMITED

I, MILDRED LUCINDA MORGAN, of the City of Toronto, Widow, MAKE OATH AND SAY as follows:

1. To the best of my knowledge and belief the attached schedule sets forth a true and correct inventory of my personal assets and liabilities on or about the 18th day of June, 1965. The funds for the acquisition of these assets were accumulated by me over a period of 38 years from my personal earnings before my marriage, gifts made to me by relatives,

[1]Exhibit 4912.

buying and selling real estate, dealing in securities and receipts from race track betting. Although no records have been kept of the numerous transactions in which I was involved over this period, the following is an outline prepared from memory, of the major transactions in the sequence of events which enabled me to acquire the assets enumerated on the schedule. Other transactions, of which no record has been kept and which I do not now recall, also assisted me in acquiring such assets.

2. I was married to my late husband on March 14th, 1936. Before my marriage, I worked as a stenographer and secretary for about 8 years, the last five of which was with the Corporations Tax Branch of the Ontario Government. During this time I saved most of my earnings as I was living at home and didn't pay any board.

3. In or about the year 1940, at a time when my husband and I were living in rented premises, my father, Mr. F. A. Wilcox, gave me a house known as 147 Castlefield Avenue, Toronto, as a home for myself and my husband.

4. In late 1942 or early 1943 my aunt, Lucy A. Clarke, whose husband had died, who had always been my favourite aunt came to live with my husband and myself. As 147 Castlefield Avenue was too small, she gave me the money to purchase 53 Duncannon Drive, Toronto. I then sold 147 Castlefield Avenue and used the proceeds to improve and renovate 53 Duncannon Drive where we lived for about three years.

5. During the time my aunt, Lucy A. Clarke, lived with me at 53 Duncannon Drive, she paid rent and board and also from time to time made gifts to me and to my children. In or about the year 1945, I sold 53 Duncannon Drive and my husband and I moved into rented premises in Toronto. My aunt at that time moved elsewhere and lived separately from us. I invested the proceeds of this sale of 53 Duncannon Drive as well as monies saved from the monies paid to me by my aunt in securities. From time to time I traded these securities and re-invested the proceeds in other securities. Much of my trading in securities at this time was done by my husband on my behalf and I have now no records of the individual transactions.

6. Some time after the sale of 53 Duncannon Drive, my aunt married George A. Way, a man of considerable wealth, and thereafter she continued to make gifts of money to me from time to time until the time of her death in June, 1961.

7. In 1947 my husband went to work in Hamilton and shortly thereafter I purchased a house in Aldershot, Ontario, and I provided the down payment on this house with the exception of about $1,000 which was provided by my husband.

8. About the year 1954 I sold the Aldershot house at a very advantageous price, the purchaser being very anxious to obtain the house. At the same time, he purchased all my household furniture along with the house. As we had before this time moved to Niagara Falls, Ontario, and were living in a furnished apartment, I then purchased 1138 Valleyway, Niagara Falls, Ontario, using the proceeds of the sale of the Aldershot

property for this purpose. The title to this house was taken in the joint names of my husband and myself. Having sold my furniture with the Aldershot property, it was necessary for me to purchase all new furniture for the new house and the proceeds of the sale of the furniture with the Aldershot house substantially covered the cost of purchasing the new furniture.

9. In 1958 my husband and I moved to Toronto but I kept the Niagara Falls house and rented it until April, 1960, when I sold it for a price of $31,500 taking back a mortgage for $20,000 as part of the purchase price. This mortgage was taken in my own name as my husband recognized that I was entitled to the proceeds of the sale.

10. At about the time I sold the Niagara Falls house, I purchased 11 St. Ives Crescent, Toronto, using the cash proceeds from the sale of the Niagara Falls property, the sum of $4,000 contributed by my husband, a portion of the monies saved and accumulated from the income and capital gains from my investments, gifts made to me by my aunt and monies received from race track betting.

11. Although I have kept no record of the gifts from time to time made to me by my aunt during the period from 1942 until her death in 1961, the aggregate amount of such gifts is probably in excess of $25,000.

12. From time to time during the period between 1945 and 1959 I received gifts of securities from my husband usually as birthday or Christmas gifts, but in no year did these exceed the sum of $4,000. In 1960, as indicated above, my husband also contributed $4,000 towards the purchase of 11 St. Ives Crescent, Toronto.

13. After moving to Toronto, I continued to deal in securities and my husband, for the most part, managed these securities for me. In January 1965, I owned 15,000 shares of Commodore Business Machines (Canada) Limited and my husband sold these on my behalf at an average price of $6.00 a share. With the proceeds of this sale, he purchased on my account, $60,000 of General Lawn Spray debentures. When he advised me that he had done this, I refused to accept these debentures as I had no confidence in General Lawn Spray Limited and I asked him to dispose of them for me. Instead of doing this, he agreed to take these debentures himself and provide me with other securities of an equivalent amount. In April 1965, pursuant to this agreement my husband turned over to me 55,000 shares of Tamarind Developments Limited which he had previously purchased for his own account. The value of these shares at the time was approximately $41,500. This left a balance of $48,500 owing to me.

14. In July, 1965, my husband transferred to me the sum of approximately $32,359.45 (U.S. funds) standing to his credit in the E. D. Sassoon Banking Company Limited, Nassau, Bahamas. This amount included some or all of the cash payment he had received from the Montreal Trust Company in connection with the acquisition of certain shares of Lucayan Beach Hotel Company Limited but I have no knowledge of how much he received for such shares nor any other particulars of the

transaction. The money was transferred to me in order to reimburse me for some expenditures which I had made on behalf of my husband and at his request in settlement of some of his personal obligations, and also to permit me to make further payments on his behalf during the time his income was reduced. Any money remaining was to be applied on account of the $48,500 owing to me as set forth in the preceding paragraph. As my husband had no income of any kind since September, 1965, almost all the money transferred to me was expended in payment of household living expenses and in payment of indebtedness owing by my husband which I paid at his request and on his behalf. This included payments on account of his indebtedness to the Toronto Dominion Bank, the Canadian Imperial Bank of Commerce and the Royal Bank amounting to $5,975.00, legal fees of $4,896.35, insurance premiums of $3,637.71, medical and funeral expenses of $2,298.35 and a large number of other items which I paid for him between that time and the date of his death.

15. Except as mentioned in this affidavit, the late Campbell Powell Morgan did not make any gifts to any of his next-of-kin during the period from 1958 to December 31st, 1965, other than the usual gifts exchanged between relatives.

16. The liabilities of the estate of the late Campbell Powell Morgan exceed the assets of the estate by an amount which, as far I have been able to ascertain, exceeds $400,000 and because of this, his estate is insolvent.

17. There are not now and never have been any assets of either the late Campbell Powell Morgan nor myself existing or in existence outside of Canada, and in particular in the United States of America or Switzerland, other than the following,—

(a) An account in the name of the late C. P. Morgan in the Freeport Branch of the Royal Bank of Canada, Freeport, Bahamas;

(b) The account in the E. D. Sassoon Banking Company Limited, Nassau, Bahamas mentioned in paragraph 14 of this affidavit;

(c) An account opened in 1952 in the name of the late Campbell Powell Morgan in Hollywood, Florida, which he maintained for vacation expenses, which account was closed during his last illness and the balance of about $40 withdrawn;

(d) An account in my own name in Miami, Florida, which was opened by me in November, 1965, with a deposit of a portion of the proceeds of the sale of shares of Tamarind Developments Limited owned by me;

(e) An account opened by me in Niagara Falls, New York, in the joint names of myself and my late husband in 1954 when we were residing in Niagara Falls, Ontario, which account was used by us for the payment of bills owing in the United States; the balance of this account, which was less than $50 was withdrawn and transferred to a new account in my name during my husband's last illness; and

(f) An account in Honolulu, Hawaii, opened by me in 1966, when I was about to make a trip to Hawaii, the balance of which account is about $229.

| | |
|---|---|
| SWORN BEFORE ME at the City of Toronto, in the County of York, this 30th day of June, 1967.<br>"L. W. Mitchell"<br>A Commissioner, etc. | "Mildred Lucinda Morgan" |

STATEMENT OF ASSETS AND LIABILITIES

| *Assets* | *Value* |
|---|---|
| Cash on hand and in bank, approximately | $ 6,200.00 |
| Investment funds held by C. P. Morgan, in trust $48,500 | nil |
| Atlantic Acceptance Corporation Limited—200 first preference shares | nil |
| Atlantic Acceptance Corporation Limited—200 second preference shares | nil |
| Commodore Business Machines (Canada) Limited—855 common shares | 800.00 |
| Aurora Leasing Corporation—$2,000 debenture | nil |
| Associated Canadian Holdings Limited—7,500 preferred shares | nil |
| Associated Canadian Holdings Limited—15,000 common shares | nil |
| Five Wheels Limited—400 common shares | 400.00 |
| Lucayan Beach Hotel Company Limited—127,410 escrowed shares | nil |
| Tamarind Developments Limited—55,000 shares | 41,500.00 |
| Dominion Leasehold Limited—1,000 shares | 200.00 |
| Mortgage on 1138 Valleyway, Niagara Falls, Ontario | 15,000.00 |
| House and premises known as 11 St. Ives Crescent, Toronto | 48,500.00 |
| Household furniture and contents of above residence | 10,000.00 |
| 1965 Cadillac automobile | 6,500.00 |

| *Liabilities* | |
|---|---|
| Realty taxes 11 St. Ives Crescent, Toronto (6 months) | $ 600.00 |
| Sheridan Nurseries Limited | 1,200.00 |
| Eatons, Simpsons and sundry charge accounts approximately | 1,000.00 |
| B. F. Williams Insurance—Insurance premium on household Floater policy | 900.00 |

Mildred Morgan evidently shared her husband's interest in speculating on the stock market and at the race-track; from this statement, given on oath, it would seem that Morgan had no right to report either the house at Niagara Falls or the house at St. Ives Crescent in Toronto among his own assets, and that the substantial sums which he showed as being receivable from his wife were fictitious. It is also possible that the cheque for $33,000 paid out of the Morgan Trust account at Freeport to General Lawn Spray, together with a $30,000 debenture of General Spray Service bought by Valley Farm and Enterprises and converted by Morgan to his own use, were intended to take the place of Mrs. Morgan's subscription for the debentures and common stock of General Lawn Spray which, according to her, she had declined to make. But the discovery, after the submission of this affidavit, of a bank account in her name, numbered 7438, at the Bayview and Eglinton Avenues branch of the Canadian Imperial Bank of Commerce, and comparison of its entries with the information contained in the documents of the Toronto-Dominion Bank relating to C. P. Morgan's credit applications and loans,[2] raises some questions about the truth of what Mrs. Morgan swore to. The account was opened on April 7, 1960 with a deposit of $13,500.32 of which $11,000 appears to have been cash received from the sale of the house at 1138 Valley Way in Niagara Falls, Ontario. On April 19 there was another deposit of $24,000, which may be explained by the $4,000 gift mentioned in paragraph 10 of the affidavit, and $21,000 for which the Toronto-Dominion Bank held a note, bearing no interest, made by Mrs. Morgan to her husband. This note was marked: "re 11 St. Ives Crescent". On April 25 the sum of $33,884.14 was paid out of the Canadian Imperial Bank of Commerce account and, since the Toronto-Dominion Bank reported that 11 St. Ives Crescent was purchased in April 1960 for $49,000, "with $34,900 paid in cash and a mortgage assumed for $14,000", it is reasonable to suppose that Morgan paid a deposit of $1,000, so that the sum of his gift of $4,000 and loan of $21,000 to his wife is sufficiently explained. The Toronto-Dominion Bank held another note, made to Morgan by his wife for $15,500, marked: "re 1138 Valley Way". Both notes were dated April 25, 1960, or contemporaneously with the sale of the house in Niagara Falls and the purchase of the house in Toronto. One is entitled, therefore, to look critically at the statements made in paragraphs 9 and 10 of the affidavit. If Morgan in fact recognized that Mrs. Morgan was entitled to the proceeds of the sale of the house in Niagara Falls, why did she give him a note identified as relating to that transaction for $15,500, as stated in paragraph 9? The Toronto-Dominion documents report a search of title disclosing that $15,500 was the amount of the mortgage indebtedness on this property, paid off before its sale in 1960. If Morgan only contributed $4,000 to the purchase of

[2]Exhibit 3878.

the Toronto house, why did she give him a note for $21,000, identified as relating to that transaction? Since both these notes were lodged with the Toronto-Dominion Bank as collateral, it may be presumed that they represented genuine indebtedness, and the assertion that she was entitled to the proceeds of the sale in Niagara Falls, and contributed all the balance over $15,000 (made up of $11,000 and $4,000) out of her savings and winnings, must be suspect. The mortgage on 11 St. Ives Crescent was paid off in 1961, but the origin of the funds used is unknown. In July 1962 C. P. Morgan was given full power of attorney on the Bayview and Eglinton account.

The contents of paragraphs 13 and 14 of Mrs. Morgan's affidavit also require some critical comment. The 15,000 shares of Commodore Business Machines, which she says she owned in January 1965, were among those redeemed by her husband and herself from Associated Canadian Holdings at $3.50 per share, in accordance with the terms of the put option agreement between that company and its shareholders described in Chapter VIII.[3] Payment for these shares was made from the Morgans' joint account in the British Mortgage & Trust office at 2200 Yonge Street, Toronto, on January 6, 1965, to Associated Canadian Holdings in the amount of $52,500. This sum was deposited in the account on December 30, 1964 and matches a payment out of Morgan's account at the Toronto-Dominion, 25 Adelaide Street West branch on December 28.[4] Her net proceeds, if they were hers, were therefore only $37,500 and do not justify receipt of the 55,000 shares of Tamarind Developments Limited at a value of $41,500, and still less her claim to an outstanding balance in her favour of $48,500, which is the basis of her claim to that portion of the funds transferred to her by Morgan standing to his credit in the Sassoon Bank and not actually spent on living and other expenses specified in paragraph 14. Tamarind Developments was a Bahamian company, affiliated with Previews International Limited, engaged in the development of real estate near Lucayan Beach; as a result of enquiries made by the Commission it seems that this was an English promotion in which Carman G. King and associates took a share interest, and according to Mrs. Morgan's solicitors the shares were never in Canada, but remained in the Bahamas until they were sold with at least part of the proceeds deposited in her Miami bank account. The affidavit, indeed, appears to be unreliable on material points, and to be aimed at the succession duty and estate tax authorities rather than designed to assist the Commission. In passing it should be noted that Mrs. Morgan asserts that the value of the house known as 11 St. Ives Crescent is $48,500, as at June 18, 1965. Since it was bought for $49,000 in 1960 and is situated in a much-favoured residential neighbourhood of Toronto, this valu-

[3]p. 370.
[4]Exhibit 2993.

ation of an unencumbered property, five years after its purchase when the price of real estate had risen markedly, is unrealistic, and the value put upon it by C. P. Morgan, in his statement of net worth submitted to the bank in 1961, of $75,000 is nearer the mark for 1965. On the whole, treatment of Mrs. Morgan's apparent assets as those of her husband in the calculation of his net worth would not appear to be unjustified.

### The Morgan Trust Account at Freeport, Grand Bahama

Wolfman's net worth calculations did not include assets which may have remained in the Bahamas after the collapse of Atlantic, other than the balance in the Morgan Trust account at Freeport, but he analysed the results of the trading in the shares of Analogue Controls in an endeavour to determine whether there was any amount there which had not been brought back and taken into account in the net worth statement. The result may be seen below.[1]

C. POWELL MORGAN

ANALYSIS OF MORGAN TRUST ACCOUNT—ROYAL BANK, FREEPORT

Based on C. P. Morgan's analyses and the cancelled bank vouchers.

| | | |
|---|---|---|
| Receipts | | |
| Barrett, Goodfellow & Co.,—Analogue sales | $1,190,000 | |
| Advance from C. P. Morgan's personal account | 60,000 | |
| Deposit from unknown source | 15,000 | $1,265,000 |
| Disbursements—Per C. P. Morgan's analysis | | |
| Selling costs—apparently paid to Frank Kaftel and Jules Schoen | 273,202 | |
| —Paid to Atlas Bank, apparently a selling cost as above | 58,500 | |
| Expenses—Bank Maerklin—re Antin | 5,000 | |
| —Carl Solomon (Racan account) | 2,500 | |
| —Miscellaneous exchange charges | 69 | |
| Repayment of Loans—N.G.K. Investments Ltd. | 169,376 | |
| —Aurora Leasing Corporation | 201,887 | |
| —Aurora Leasing Corporation | 59,046 | |
| —Barclay's Bank (re L.B.H. Management Co.) | 100,000 | |
| —E. D. Sassoon's Bank—interest | 13,870 | |
| —Recipient unknown | 75,000 | |
| Personal advances—Annett & Co. re C.B.M. warrants | 69,036 | |
| —E. D. Sassoon's Bank | 41,000 | |
| —Recipient unknown | 20,000 | |
| —General Lawn Spray Limited | 33,000 | |
| Other item—recipient unknown—apparently a selling cost | 22,500 | |
| | $1,143,986 | |
| Disbursements following the date of C. P. Morgan's statement | | |
| Repaid to C. P. Morgan's account at Toronto Dominion | 20,000 | |
| Paid 25,000 U.S. apparently to L.B.H. Management Company | 27,207 | |
| Balance paid to unknown recipients (May 26/65 to Oct. 4/65) | 73,807 | $1,265,000 |

[1]Exhibit 3891.

This in turn is based on an analysis, written in pencil in C. P. Morgan's hand, on the back of a Walton, Wagman & Co. envelope containing cancelled cheques and bank vouchers, and another handwritten summary entitled "Interim Statement at April 30, 1965", both of which apparently refer to the Analogue trading and the disposition of its proceeds. These documents, together with the cancelled cheques of the Morgan Trust account, were among those delivered by Mrs. Morgan to Detective Smythe[2] and, together with the ledger card produced by the Royal Bank for this account[3] and the schedule compiled by Mr. Gillman of the Ontario Securities Commission, estimating the profit from Analogue trading,[4] provided material for the analysis shown above. The gross amount paid into this account, from the time it was opened in February 1965 until the collapse of Atlantic, was $1,265,000 of which $1,190,000 definitely came from the sale of Analogue stock through Barrett, Goodfellow & Co., plus a further $60,000 advanced from Morgan's personal account at the Toronto-Dominion Bank in Toronto, and a $15,000 deposit the origin of which has not been determined. It is possible to say with some certainty that $273,202 was paid to either Frank Kaftel or his agent, Jules Schoen. A further $58,500 is included above under the heading "Selling Costs", as were all the amounts going to Kaftel or Schoen, and this was paid by cheque dated April 3, 1965, signed by C. P. Morgan for "Morgan Trust" and drawn in favour of the Atlas Bank Limited, a Nassau enterprise which duly endorsed the cheque by the hand of its manager, F. F. Morger: "pay to the order of any Bank, Banker, or Trust Company. Prior endorsements guaranteed." Inquiries about the Atlas Bank were made in Nassau by the Commission's accountants whose memorandum[5] stated that it was incorporated in the Bahamas on November 2, 1963 and that its name was subsequently changed on April 1, 1966 to International Credit Bank (Bahamas) Limited. The directors in 1967 were Dr. Tibor Rosenbaum, Charles A. Junod, Henry Mattis, all of Geneva in Switzerland, the Honourable Peter D. Graham, Nassau, Felix Fenston of London, England, and Bernard Bloomfield of Montreal, described as a "petroleum executive". Rosenbaum and Mattis were president and vice-president respectively of a concern called International Credit Bank in Geneva.

The figures on the back of Morgan's envelope, a photograph of which appears opposite,[6] appear to constitute an analysis working sheet under six headings, the first column being "Repayment of Loans", the second "Selling Costs", the third "Expenses", the fourth "Receipts", the

[2]Exhibit 3862.
[3]Exhibit 3591.
[4]Exhibit 2444 and Chapter VIII, pp. 474-5.
[5]Exhibit 3892.
[6]Exhibit 3862.

| | Repayment of L. | Pooling Costs | Expenses | Receipts | Personal advances (&) |
|---|---|---|---|---|---|
| | | | | 350000 | 35000 |
| | | | | 35000 | 25000 |
| | 371 363.09 c | | ·90 | 175000 | |
| | 100.000. c | 4600 c | 5000.— c | 200.000 | |
| | 13 870 11 c | 41400 c | 2500 — c | 100.000 | |
| | 59 046 c | 76400 c | 37 | 150.000 | |
| | 75000 | 2900 c | 7501.27 | 150.000 – | |
| | 619.279 20 | 23500 c | | 25 000 | |
| | | 130 800 | | 1185 000 | 2500.00 |
| | | 20 000 c | | 60 000 | |
| | | 32 000 c | | 1125.000 | |
| | | 29600 c | | | |
| Then. | | 37720 c | | | Personal advances |
| | | 4700 c | | | |
| | | 42382 50 c | | | |
| | | 15000 c | | | 69036 25 |
| | | 362.202 50 | | | 41000 |
| | | 2500 | | | 20000 |
| | | 364.702 50 | | | 33000 |
| | | | | | 163.036 25 |
| | | | | | 62 500 |
| | | | | | 100 536.25 |

fifth "Personal Advances—Credit" and the sixth "Personal Advances—Debit". These amounts were compared with the cancelled cheques and bank statements found in the envelope, and the selling cost cheques found to be mostly payable to the Royal Bank of Canada and endorsed "Jules Schoen". There can be little doubt that these cheques were issued in payment of the commission to Kaftel, arranged between him and Morgan on the sale of the shares of Analogue Controls, and were used to purchase bank drafts as described by himself.[7] In his column headed "Selling Costs" Morgan showed a sub-total of $130,800 and a grand total of $364,702.50; neither of these agree with the detail of the calculation, the sub-total being high by $33,000 and the grand total high by an additional $58,500, the latter being the amount paid to the Atlas Bank and for this reason attributed by Wolfman to selling costs. Morgan shows expenses in two amounts which correspond with cheques of $5,000 to Maerklin Bank in Frankfurt, "re Antin" as shown in the cheque book, and for $2,500 payable to Carl Solomon and marked by the latter as "deposit only to the credit of Carl M. Solomon (Racan account)". Solomon, as already described, explained that this was a payment for Morgan's share of losses incurred by Solomon, Singer and himself in the purchase of stock of Racan Photo-Copy Corporation, which Morgan obviously wished to keep secret because other cheques in relation to this venture were marked "retainer".[8] From the Commission's knowledge of the part played by the Maerklin Bank and Harold Antin in the distribution of shares of Commodore Business Machines it is easy to believe that the first of these payments was properly classified as an expense, but such a characterization of the payment to Solomon is not easily explained. In Morgan's handwritten column headed "Repayment of Loans" the first figure is the sum of two amounts payable to N.G.K. Investments and Aurora Leasing, shown as the first and second items on the Wolfman analysis of the Morgan Trust account to the nearest dollar, and Morgan's fourth figure of $59,046 corresponds with another payment to Aurora Leasing shown as the third figure under the same heading on the Wolfman analysis. An interest payment of $13,870.11 to the E. D. Sassoon Banking Company can also be identified, but not specifically the amount of $75,000 as shown on the analysis opposite the notation "recipient unknown", since there is no corresponding cheque in that amount; yet, about a week after the date of Morgan's statement, $75,000 was deposited in his personal account at the Toronto-Dominion Bank in Toronto and the transfer of that sum by draft would explain the absence of a cancelled cheque, although a bank slip in connection with the draft is similarly missing from the records and there is likewise no cheque to the Royal Bank in payment of the draft. Finally, the $100,-

[7]Evidence Volume 26.
[8]Chapter XI, pp. 779-80.

000 figure shown under "Repayment of Loans" corresponds to a payment out of the account to Barclay's Bank in Nassau for an investment in L.B.H. Management Company.

Under "Personal Advances" Morgan paid $69,036 to Annett & Co. for warrants of Commodore Business Machines which have already been taken into account in the calculation of his trading in securities of that company. Under that is shown a payment of $41,000 which was made to the Sassoon Bank for a purpose which is not known but which may have been a repayment on his $250,000 loan. The same may be said of Morgan's third entry of $20,000, although with even less certainty, because there is no corresponding cancelled cheque. The final entry of $33,000 was the advance to or investment in General Lawn Spray, and for some reason, perhaps connected with the supposition that it was a payment made to replace Mrs. Morgan's subscription, appears to have been regarded by Morgan as a selling cost, because it is the same amount by which his selling costs sub-total exceeds the sum of the amount shown. Mr. Wolfman considered Morgan's total for selling costs as being approximately correct on the assumption that the $33,000 included in it was properly part of his personal advances, whereas $22,500 withdrawn from the Morgan Trust account, and the destination of which is unknown, had probably been included in the selling costs. These adjustments, with the addition of another for $2,500 which Morgan shows in his handwritten analysis, would account approximately for the figure of $364,702.50 which he showed.

Morgan's own analysis was dated April 30, 1965, and was summarized by him on the second handwritten sheet found inside the envelope on which the working figures were written.[9]

"Interim Statement
to 4/30/65

| | | |
|---|---|---|
| Sales | | 1,125,000 |
| Expense | 364,702.50 | |
| | 7,501.27 | |
| | 372,203.77 | |
| Repaid Loans | 619,279.20 | |
| A/Cs Rec. | 100,536.25" | |

Wolfman was able to trace two other payments out of the Morgan Trust account made after that date, one being for $20,000 to Morgan's account at the Toronto-Dominion Bank which was considered in the calculation of his net worth, and another for $25,000 in U.S. funds, or $27,207 in Canadian funds, advanced to L.B.H. Management; the note on the cheque book is "re L.B.H.", and is also shown on the financial

[9]Exhibit 3862.

statements of that company for May, 1965.[10] Two subsequent withdrawals of $22,500 and $2,500 may have been additional selling cost paid to Kaftel which, if added to Morgan's calculations, would increase the total to $389,702.50. This supposition must remain a matter of conjecture, but it is reinforced by a most persuasive coincidence. Mr. Gillman's calculation of Kaftel's receipts from the trading in the shares of Analogue Controls, on the basis of his obtaining any excess over $4 per share of those sold, was in the amount of $389,707.50, or only $5 more than Mr. Wolfman's, and was made independently, at an earlier date, and without the benefit of the revealing documents found in Morgan's house in February 1967. If the shares of Cimcony Limited with a face value of $300,000, which Morgan's Mortgage Trust & Savings Corporation received in exchange for 75,000 shares of Analogue Controls, are left out of account, as they may well be, and the selling expenses of the Analogue stock are assumed to be what these two estimates indicate, Morgan must have made a net cash gain on the Analogue trading of $371,721. Looking at the analysis of the Morgan Trust account which contains an estimate of what Morgan was able to retain, amounting as valued at June 17, 1965 to $442,716, it seems that this amount must be reduced by at least $55,000, made up of the advance to the Morgan Trust account of $60,000 from his Toronto-Dominion Bank account at Toronto, less a repayment to that account of $20,000 plus the deposit from an unknown source of $15,000, which brings the amount apparently retained measurably closer to the estimated profit; there is still some $16,000 to be accounted for, the presence of which is unexplained. In any event the whole of Morgan's advances to L.B.H. Management of $127,207, and of $33,000 to General Lawn Spray, were lost as a result of the Atlantic collapse, and the $69,036 paid for Commodore Business Machines warrants declined to a value of perhaps $16,000; the balance consists of the amount on deposit at the Royal Bank in Freeport at June 17, 1965 of $63,603, and money paid to the Sassoon Bank and other recipients who are unknown, amounting to $149,870.

### Morgan's Credit at E. D. Sassoon Banking Company

That there can only be a guess as to what additional funds may have been available to C. P. Morgan at the E. D. Sassoon Banking Company in Nassau, as the result of his having assumed the Freeport International loan of $250,000 secured by 250,000 old shares of Lucayan Beach Hotel Company in March 1964, is the effect of the peculiar banking laws of the Bahama Islands which, as already seen, were amended after the Atlantic collapse to provide additional cloaks behind

[10]Exhibit 1090.

which the transactions of depositors can be concealed; but it is only fair to say that the ready response of Canadian banking institutions to the requests of the Commission for information on depositors' affairs could not be expected from another jurisdiction. Among the documents found at 11 St. Ives Crescent were two cheques, in a file of Morgan's labelled "Lucayan Beach Hotel & Development",[1] payable to the Sassoon Bank, one for $10,000, dated March 3, 1964, and the other for $15,000, dated March 25, 1964. These were drawn on his account at the Toronto-Dominion Bank in Toronto and therefore do not appear on the analysis of the Morgan Trust account, which does, however, record the cheque drawn on it in favour of the Sassoon Bank, dated February 26, 1965, for $41,000. Again the possibility that the $75,000 shown in Morgan's calculations under "repayment of loans", and shown on Wolfman's Morgan Trust account analysis under the same heading marked "recipient unknown", may not be related to the deposit in his Toronto account at the Toronto-Dominion Bank, but may have been a further payment on the Sassoon loan, cannot be dismissed. Another payment of $20,000 was made from the account for which no cancelled cheque has been found, which may, or may not have been made to reduce the loan. Some light on the nature of the transaction is cast by documents in the possession of the Montreal Trust Company,[2] dealing with its own acquisition of the 1,250,000 new shares which were security for Morgan's loan of $250,000 in July 1965. Obtaining these shares was essential to its control of Lucayan Beach Hotel and Development Limited, and it has been seen that Morgan claimed credit for securing them for the trustee.

The Montreal Trust Company paid E. D. Sassoon Banking Company $274,598.61, as was said in a letter from D. B. MacKlaier to P. D. McCaughey, comptroller of Atlantic Acceptance Corporation, dated August 10, 1965, made up of the principal amount of Morgan's loan of $250,000 plus interest from March 4, 1964 to July 30, 1965.[3] Since this was the case, the Sassoon Bank was accountable to Morgan for whatever he had paid to reduce it in the meantime. Here the payment of $13,070 to the Sassoon Bank on March 25, 1965, out of the Morgan Trust account and identified as interest on the stub of Morgan's cheque book, takes on some significance, if only of a conjectural nature. The payment was made a little over a year after Morgan's assumption of the Sassoon loan to Freeport International and, if it is interest on the full amount of $250,000, denotes an interest rate of approximately 5.5%. Since the rate was more probably 6%, and $13,870 approximately that on a fund of $225,000 paid one year later, there is more support for the assumption that the two payments amounting to $25,000, made from his

[1]Exhibit 3817.
[2]Exhibit 3893.
[3]Exhibit 3893.

Toronto-Dominion Bank account in March 1964, were to reduce principal of the loan. The later payments made in 1965 were not less than \$41,000, for which a cancelled cheque drawn in favour of the Sassoon Bank exists, and possibly as high as \$136,000 if it is assumed that the two withdrawals of \$75,000 and \$20,000, for which there are no cheques and no other indicia of destination, were payments to the same institution. Mr. Wolfman thought that the total of such payments would not have been more than \$100,000 and, in this connection, the statement in Mildred Morgan's affidavit that her husband turned over to her from his dealings with the trustee "the sum of approximately \$32,359.45 U.S. funds standing to his credit in the E. D. Sassoon Banking Company Limited, Nassau, Bahamas"—hardly an approximation when all is said and done—must also be taken into account. Indeed she went on to say that "this amount included some or all of the cash payment he had received from the Montreal Trust Company in connection with the acquisition of certain shares of Lucayan Beach Hotel Company Limited but I have no knowledge of how much he received for such shares nor any other particulars of the transaction". The state of her knowledge was not unlike that of the Commission, and here the matter must be allowed to rest except for the observation that, because of the prevailing uncertainty and the lack of evidence that any such funds had returned to Canada, Mr. Wolfman did not take them into account in calculating C. P. Morgan's net worth.

**The Atlas Bank**

A further excursion must be made into the realm of conjecture, if only to show the extent to which the Commission's inquiries were pressed and of the obstacles placed in its path. Morgan's payment of \$58,500 out of his Freeport account to the Atlas Bank was the most baffling of all his Bahamian transactions. The fact that it was exactly 15% of \$390,000, which, to the nearest thousand dollars, was the estimated amount of his selling costs and expenses in the manipulation of Analogue shares, was tantalizing as a point of departure for further speculation, but otherwise unhelpful. It was accordingly decided to try to enlist the co-operation of the only Canadian director of the Atlas Bank, Mr. Bernard M. Bloomfield of Montreal. He was president of Israel Continental Oil Company Limited, an Ontario corporation which, according to its notice published in "The Financial Post Survey of Oils 1968", acquired in late 1960 a 40% interest in a Saskatchewan development programme from New Continental Oil Company. Since New Continental Oil was a promotion of the late Frank Kaftel upon which the Ontario Securities Commission has passed unfavourable judgement, and, from other information in the possession of this Commission, Bloomfield was

believed to have associated with Kaftel, Detective-Sergeant Angus of its investigating staff attempted to see him in his Montreal office on December 11, 1968. Bloomfield was not available at the time, but subsequently spoke to Angus on the telephone saying that he had not seen Kaftel for many years, that he had no real knowledge of the affairs of the bank, and that in any event the Bahamian banking laws precluded him from disclosing what he had. He said further that he was much too busy to give Angus an interview at that or any later time, even for a few minutes, but after the conclusion of this conversation he called the investigator back and expressed some interest in the details of the $58,500 cheque, although he disclaimed any knowledge of the man who drew it. The reluctance of Mr. Bloomfield to discuss these matters, other than over the telephone, is perhaps understandable, but it is in noticeable contrast to the attitude of his brother, Mr. L. M. Bloomfield, Q.C., also a director of Israel Continental Oil, who was most co-operative at an earlier date in giving the same investigator information as to the part played by his law firm in the application for listing the shares of Commodore Business Machines on the Canadian Stock Exchange. It is tempting to think that these straws in the wind point to Kaftel as the ultimate recipient of the money paid to the Atlas Bank; but since it did not follow the path taken by other payments to Kaftel, the method of payment is at least consistent with some one else having received it, and not inconsistent with Morgan himself having deposited it in a Swiss account, since the Atlas Bank was not then licensed to conduct a banking business in the Bahamas and did not become so until September 7, 1966, after it had changed its name to International Credit Bank (Bahamas) Limited. There were, of course, other possible recipients of Morgan's bounty operating in the Bahamas at the time, in the persons of Eugene Last, David and Myer Rush and George H. Weinrott, all of whom possessed knowledge on which some price for silence might be set.

### The Kaftel Payments

An attempt must also be made to pull together the various threads of evidence leading to Frank Kaftel, in Luxembourg or Paris as the case may be. These have already been exposed, in connection with the marketing of the shares of Commodore Business Machines, in Chapter VIII where Morgan's relationships with Kaftel have been examined in some detail,[1] and the use of the Daylite of Grand Bahama accounts in the Bank of Nova Scotia in Toronto for transferring to Kaftel sums of money derived from Morgan's brokerage accounts;[2] the Analogue trading has also been referred to at length in that portion of Chapter VIII

[1]pp. 373-85.
[2]pp. 393-4.

devoted to the affairs of Analogue Controls,[3] and in Chapter IX, where all of Morgan's involvement in the Bahamas was reviewed, a further reference has been made.[4] The evidence of Messrs. Wolfman, Burn and Gillman described what was known about the part played by Kaftel through his International Financial Advisory Service, and by personal recommendation in promoting the sale of the shares of these two companies on the Continent, but some concluding observations should be made on this carefully-concealed association in conjunction with the estimate of Morgan's net worth. Looking again at the "Source and Disposition of Known Cash Gains Related to Atlantic Acceptance Corporation",[5] it will be seen that, between July 1963 and June 17, 1965, Morgan's estimated gross cash gain from the sale of Commodore Business Machines common shares was $372,008, and that all cash profits were apparently paid to Kaftel as his commission, pursuant to an agreement that he would receive everything over $3.50 per share and that Morgan would retain the balance. In substantiation of this, the list of Bank of Nova Scotia cheques for the Daylite of Grand Bahama account, which were discovered among Morgan's papers at 11 St. Ives Crescent, all payable to F. Kulunderino and all endorsed by the same hand as previously reported may with advantage be reproduced again.[6]

| *Date* | *Amount* | *Deposited to credit of* |
|---|---|---|
| June 26, 1964 | $ 45,000 | Galco Trust Reg. |
| October 14, 1964 | 35,000 | A. Gillieron & Banque Jordaan S.A. |
| October 26, 1964 | 25,000 | L. G. Beaubien, J. L. Levesque Inc. |
| November 5, 1964 | 25,000 | W. C. Pitfield Company Ltd. |
| November 12, 1964 | 25,000 | Boucqueau Luyckx & Co. |
| November 19, 1964 | 25,000 | W. C. Pitfield & Company, Montreal |
| November 27, 1964 | 25,000 | W. C. Pitfield & Company |
| December 8, 1964 | 25,000 | W. C. Pitfield & Company |
| January 8, 1965 | 10,000 | W. C. Pitfield & Company |
| January 15, 1965 | 25,000 | W. C. Pitfield & Company |
| January 22, 1965 | 25,000 | W. C. Pitfield & Company |
| January 29, 1965 | 27,500 | W. C. Pitfield & Company |
| February 6, 1965 | 12,500 | W. C. Pitfield & Company |
| February 12, 1965 | 42,400 | W. C. Pitfield & Company |
| | $372,400 | |

[3]pp. 419-78.
[4]pp. 660-3.
[5]Exhibit 3886.
[6]Exhibit 3894.

Morgan was left with 81,286 shares, with a market value before the collapse of over $400,000, which, however, were pledged to cover various loans and were sold out by his creditors at a much lower rate, insufficient to pay his debts. Between October 1964 and May 1965 the sale of shares of Analogue Controls, amassed by Mortgage Trust & Savings Corporation, grossed $761,429, out of which it is assumed that $389,708 went to Kaftel through Jules Schoen and by other means. Morgan's net gain on the Analogue sales was $371,721, all of which, as has been seen, was disbursed from the Royal Bank account at Freeport. Kaftel, therefore, in spite of his disclaimer to the Commission in Paris in March 1967, perhaps received, for his services in both market operations for whatever distribution he thought fit, the very large sum of $756,100, or $697,600 if one deducts the amount paid to the Atlas Bank on the supposition that it went elsewhere. The only other person, according to Morgan, who was entitled to any part of this was Schoen in respect of his 10% of the Analogue commission, which would amount to some $39,000 if one includes the Atlas Bank payment, and some $33,000 if one does not. Although from time to time Schoen has been heard of in the United States, the Commission has never been able to make any sort of contact with him.

The actual disposition of the funds which Kaftel is presumed to have received is still, as has been said before, wrapped in mystery. If Kaftel and his associates got all this money, the cost of Morgan's operation in the market for Commodore Business Machines and Analogue Controls shares was high indeed, and a measure of the length he was prepared to go, and the energy he was prepared to expend to make his fortune in this way. His version of the arrangement with Kaftel has already been quoted in Chapter VIII,[7] and the gist of Kaftel's statement, and the circumstances of his giving it to the Commission in Paris in March of 1967, also set out in the same place.[8] The whole of Kaftel's statement, as reduced to writing by Mr. Shepherd and perused and signed by Kaftel, with the relevant amendments made in his own hand, has been reproduced as Appendix G, and it will be seen that, although Morgan said that Kaftel received approximately $375,000 for the Analogue Controls promotion, Kaftel had a different story to tell. Although Morgan's evidence was given on oath, and in a very real sense in the settled expectation of death, Kaftel's statement was not, and indeed he had declined a suggestion that it should be sworn; none the less some weight should be given to the fact that Kaftel knew himself to be a victim of incurable heart disease, and had approached the Commission with a request that his story be heard. Having heard the two men I am inclined to prefer Morgan's version of what transpired to Kaftel's where

[7]pp. 465-9.
[8]pp. 469-70.

they are in conflict, but the possibility that substantial sums, which the latter felt he was entitled to, were diverted by Morgan into other channels cannot be dismissed, especially when it is remembered that if Morgan were making deposits in Swiss banks, as Kaftel suggested was the case, with a view to transmitting them surreptitiously to his heirs, he would have been powerfully influenced not to disclose the fact to anyone but them, even in the final moments of his life.

### Effect of the Collapse

In estimating Morgan's net worth no attempt was made by Mr. Wolfman to include any value for his possible interest in such companies as Hugo Oppenheim und Sohn, Evermac Office Equipment, Trans Commercial Acceptance, Baronet Associates and a number of others which Messrs. Tramiel and Kapp vigorously asserted belonged to him, and not themselves as the records indicated. This was an omission which, according to my view of their evidence, was fully justified. The principal reason for the decline in value of Morgan's assets between June 11 and July 2, 1965 was the shrinkage of over $2,000,000 worth of Commodore Business Machines securities to a market valuation of some $770,000. At July 2 the common stock of Atlantic Acceptance still retained some market value, but Morgan's holdings had also depreciated by some $350,000. The total decline in market value of the listed securities, shown in the analysis of his net worth[1] in that period, was $1,636,000 in round figures, and the companies affiliated with or related to Atlantic Acceptance, the securities of which were unlisted and held by Morgan, mostly became insolvent and eventually bankrupt, wiping out a book value of $463,098. The loss in market and book value of securities in both these categories in the space of two weeks amounted to $2,099,000 and left him with negligible assets. After July 2 the position would have worsened; even though his Commodore Business Machines debentures were redeemed by that company at 75¢ on the dollar, no significant difference would have occurred in his net worth, since they were valued for the estimate at 70% of their face value. The common shares, which had a market value of $2.85 at July 2, were eventually sold out on settlement at a price of $1.50 per share; the fact that they had, by the end of 1968, been traded at prices upwards of $10 per share is interesting but irrelevant.

### Systematic Conflict of Interest

A characteristic activity of C. P. Morgan, supplementing his operation of the lending of the Adelaide Street subsidiaries of Atlantic Acceptance Corporation, and of Aurora Leasing Corporation and

[1]Exhibit 3887.

N.G.K. Investments which also derived all their funds from Atlantic, was the use of private companies as borrowers of Atlantic funds in which he, and usually W. L. Walton and Harry Wagman, owned all the shares, legally or beneficially. One such example has already been treated in some detail in Chapter XIII dealing with the affairs of Valley Farm and Enterprises. Another was Canada Motor Products (Toronto) Limited, the name of which was changed on April 1, 1963 to Gassem Enterprises Limited, and which also conducted a genuine business apart from the lending and borrowing appearing on their books with considerable frequency. The affairs of the "Gassem group", also referred to in Chapter XIII,[1] were examined for the Commission by Louis M. Nuspl, C.A., of Touche, Ross, Bailey & Smart,[2] and are sufficiently complex, involving as they do an attempt by the Trio to carry on for their own benefit the business of a bankrupt company, Canada Motor Products Limited, owned by Israel M. Gringorten and his family.[3] By March 1962 Canada Motor Products Limited was indebted to Commodore Sales Acceptance in the amount of $238,008.86,[4] was petitioned into bankruptcy and fell into the hands of W. L. Walton as trustee. Canada Motor Products (Toronto) Limited had been incorporated on February 6, 1962, on the petition of W. L. Walton, Harry Wagman and S. S. Chusid, to take over the inventory of the bankrupt company and to assume $200,000 of its debt to Commodore Sales Acceptance. At various times in 1962 its directors were the three petitioners or George Kingston, Albert A. Shelman, Monie Julian Cruz, A. S. Turner, John Canning, L. Murray Eades and Shirley Fruitman; finally the last three were settled on as nominees for the Trio. In the course of its undistinguished life as a Trio company Canada Motor Products (Toronto), or Gassem Enterprises, attempted a joint venture, with Blackstone Manufacturing Incorporated of Chicago, to market automobile parts of the Blackstone line in Canada by incorporating another company called Canada Motor Products (Blackstone) Limited; it also played a modest but convenient rôle in the Trio's participation in the underwriting of the shares of The Dale Estate Limited. It may be sufficient to say for the purposes of this report that, after the bankruptcy of Gringorten's company, its successor continued to borrow Atlantic funds from Commodore Sales Acceptance, N.G.K. Investments and Valley Farm and Enterprises, the estimated losses of which at December 31, 1965 were $140,000, $125,000, and $60,000 respectively in relation to these loans.

Since Dallas Holdings Limited, mentioned in the preceding pages, did not pretend to fulfill any function other than investing for profit, it may well be looked at again as an example of a Trio private company

[1] pp. 856-7.
[2] Evidence Volume 59.
[3] Evidence Volume 60.
[4] Exhibit 3036.

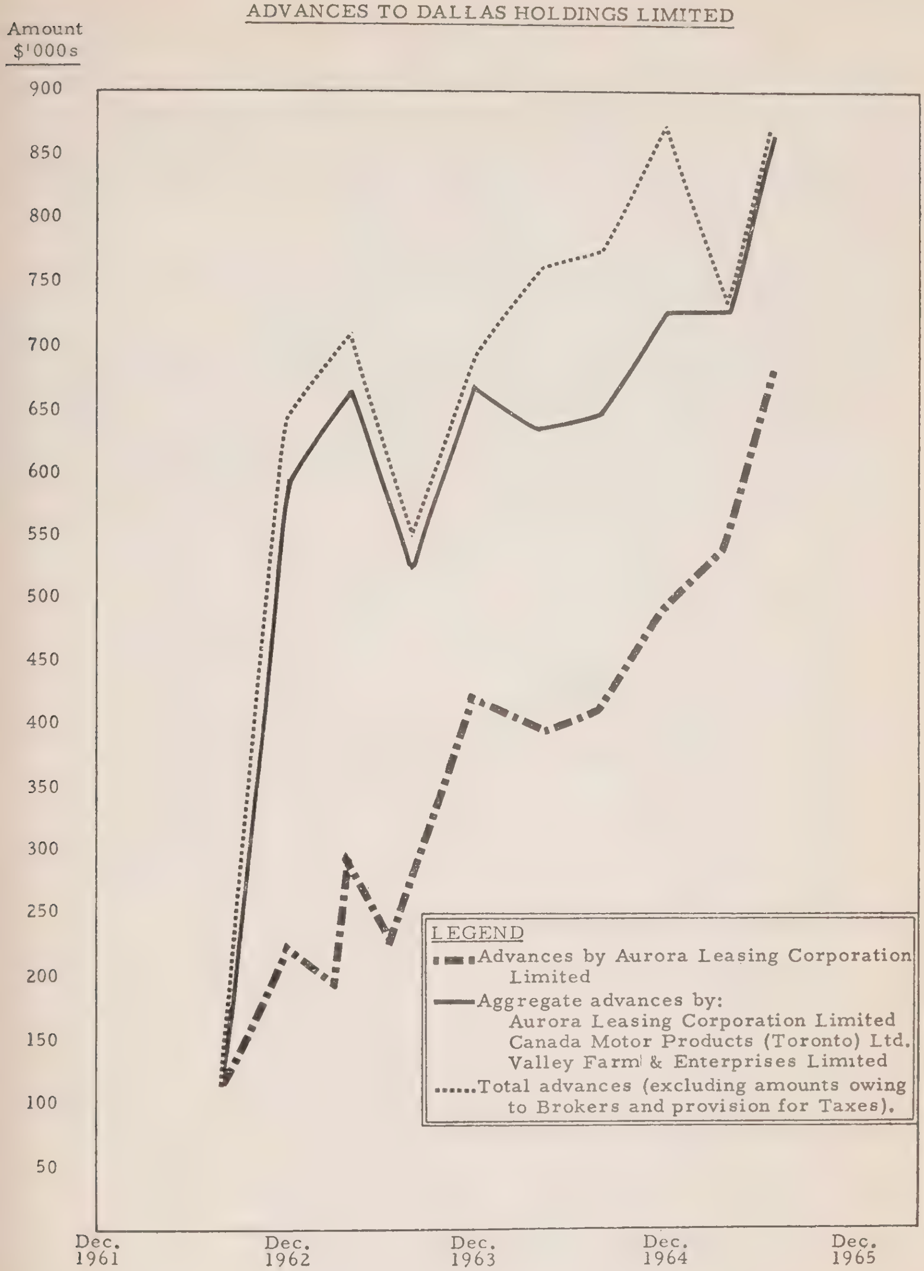
using Atlantic funds and incurring very substantial losses in its efforts to enrich its shareholders. The affairs of the company were examined for the Commission by H. B. Walker, C.A., of Touche, Ross, Bailey & Smart,[5] who testified about them before the Commission on February 24, 1967. It was incorporated on February 4, 1955 through the efforts of Rennie A. Goodfellow, who became its president on September 24, 1956 and remained so until he was replaced by C. P. Morgan on December 22, 1961. The issued capital was never any more than three common shares subscribed for at $1 each, Morgan acquiring his one share on November 16, 1961, and Walton and Wagman theirs on December 22.[6] On the Trio's statement of investments for August 31, 1962 these shares are shown as having a value at cost of $3,950.[7]

The schedules prepared by Mr. Walker to illustrate the operations of Dallas Holdings at December 31, 1961, 1962, 1963 and 1964 and July 30, 1965 consist of an analysis of assets[8] and of liabilities[9] at those dates, which may be seen together as Table 79, an analysis of securities held at each balance sheet date at Table 80,[10] the operating results for each of these periods at Table 81[11] and an estimate of the losses on the securities held by the company at July 30, 1965 at Table 82.[12] With reference to the analysis of liabilities, it should be pointed out that in this case, as in that of all these schedules, figures up to and including December 31, 1964 are derived from the financial statements prepared by Walton, Wagman & Co. and Wagman, Fruitman & Lando. Therefore the liability to A. S. Manus, first appearing at December 31, 1964 in the amount of $67,723, and shown as outstanding at July 30, 1965 in the same amount, must be considered in the light of what has already been reported in Chapter IX[13] about the origin of this so-called debt. The company was declared bankrupt in July 1965 and it is not likely that the trustee will acknowledge Manus's claim.

A graphic illustration of the source of funds for Dallas Holdings is shown opposite.[14] The detail is supplied on Table 79 which shows that advances of Atlantic funds by July 30, 1965 through Aurora Leasing Corporation amounted to $678,850, and through Valley Farm and Enterprises to $187,050, and accounted for 83.1% of the company's accounts payable. Dallas lost money in every period of its operations except 1961, during which, as has been seen, it was acquired by the Trio. At December 31, 1964 its net loss was $22,731 and its deficit $156,036,

[5]Evidence Volume 101.
[6]Exhibit 4108.
[7]Table 30.
[8]Exhibit 4111.
[9]Exhibit 4109.
[10]Exhibit 4112.
[11]Exhibit 4113.
[12]Exhibit 4114.
[13]p. 520.
[14]Exhibit 4110.

ADVANCES TO DALLAS HOLDINGS LIMITED



whereas for the seven months ended July 30, 1965 the loss was $111,204 and the deficit $267,240. It played its part, however, as seen in Chapter VIII, in making a market for both the shares of Commodore Business Machines and those of Analogue Controls, its purchase and sales being solely under the direction of C. P. Morgan. In this connection the following document was significantly located in the envelope containing the Kulunderino cheques,[15] and though only a copy, undated and unsigned, puts the company in its proper setting.

> Barrett, Goodfellow & Company Limited
> 330 Bay Street
> Toronto, Ontario
>
> We hereby acknowledge and agree that the trading done by us through you has been for our joint accounts and we acknowledge that any securities deposited with you in any of the accounts may be dealt with by you in the same manner as if deposited with respect to any other one or more of such accounts, and looked to as security for any debits in any of such accounts.
>
> ..........................................
> Walter Pahn
>
> ..........................................
> C. Powell Morgan
>
> DALLAS HOLDINGS LIMITED
>
> Per: ..........................................
>
> Per: ..........................................
>
> N.G.K. INVESTMENTS LIMITED
>
> Per: ..........................................
>
> Per: ..........................................
>
> VALLEY FARMS LIMITED
>
> Per: ..........................................
>
> Per: ..........................................
>
> YARRUM INVESTMENTS LIMITED
>
> Per: ..........................................
>
> Per: ..........................................

[15]Exhibit 3862.

ASSOCIATED CANADIAN HOLDINGS LIMITED

Per:..................................................................................

Per:..................................................................................

MASCO CONSTRUCTION COMPANY LIMITED

Per:..................................................................................

Per:..................................................................................

The estimated losses on the securities held by Dallas Holdings at the end of its life, as illustrated on Table 80, were $696,000 out of a balance sheet value at July 30, 1965 at $773,636. The adjusted deficit may be seen at the foot of Table 82 and for convenience is reproduced here.

ADJUSTED DEFICIT

| | | | | |
|---|---|---|---|---|
| Deficiency of shareholders' funds July 30, 1965 | | | | |
| Revenue deficit ...... | $267,240 | | | |
| Deduct issued capital .................... | 3 | | | |
| | | $267,237 | | |
| Estimated loss on realization of assets (as above) ................. | | 696,000 | | |
| | | | $963,237 | |
| Deduct liability to Barrett, Goodfellow & Co. offset by the securities held by that firm at July 30, 1965 ....... .... | | | 93,617 | |
| | | | | $869,620 |

The amount of this loss of Atlantic funds to market operations, carried on solely for the benefit of C. P. Morgan and his associates, is by no means inconsiderable. Here again the existence and activities of the Wagman firm—A. M. Lando replaced W. L. Walton as a shareholder on November 11, 1964—were indispensable to the operations of this company, since they kept the books and prepared the accounts. No wonder, as several witnesses testified, Morgan's whereabouts could always be established, when not otherwise known, by telephoning Harry Wagman in whose office he could generally be found.

**C. P. Morgan and the Atlantic Directors**

In the preceding sections of this report the transactions of the board of directors of Atlantic Acceptance Corporation have been frequently referred to, as have the activities of the individual members of the board

in certain situations. A list of its members, with the dates of their appointments and the resignations of those who disappeared from the board before the date of default in June 1965, appears in Chapter II.[1] During most of the period under review the board consisted of seven members, of which Alan T. Christie, William H. Wallace and A. C. Rooney represented the interest of Great Northern Capital Corporation, which was controlled, in turn, by Lambert & Co. from New York. After Rooney's resignation in June 1964 he was replaced by Paul C. Sheeline, a Lambert partner, and when in May 1965 the membership of the board was increased from seven to nine both of the new vacancies were filled by Lambert nominees, in the persons of James E. McConnell and Jacques Kayaloff, to give effect to Great Northern Capital's acquisition of the majority interest in the common shares, amounting to 53% of the whole in 1964; the lapse of many months at a critical period between this achievement and the appointment of a clear majority of Lambert nominees was attributed by Davidson to Christie's reluctance to remove any of the existing members, and the decision to wait until supplementary letters patent were obtained increasing the membership, so that the majority could be secured by adding new directors rather than replacing old ones. Since C. P. Morgan had always been regarded by the Lambert partners as their own man at Atlantic, they probably considered the position of Great Northern Capital predominant at all times. Christie, who replaced D. B. Mansur on the board in 1960, was, as president of Great Northern Capital and second in seniority among the Lambert partners, the acknowledged leader of that interest; Rooney, as executive vice-president of Great Northern Capital, was clearly his subordinate, and Wallace, who spent a large part of the winter in Florida, was an infrequent attendant at meetings of the board. Among the other directors, J. Aubrey Medland, Wilfrid P. Gregory and Walter H. Martin, only Medland, who had known Morgan longer than anyone else and who was vice-president of the company, could be described as an active member, and he in many respects was the most active of all, frequently visiting the company's offices, both at Oakville and in Toronto, and asking so many pertinent questions in and out of board meetings as to be described by the company's president as "meddling Medland". Martin, a manufacturer in Hamilton, had been on the board of Atlantic since 1954 and, like the senior partner of Wright, Erickson, Lee & Macdonald and Davidson himself, had been a golfing associate of Morgan's in Burlington; although in point of time his service as a director was the longest, the finance company business was far removed from his own sphere of activity and he made no attempt to influence the company's policy. Gregory was a regular attendant at meetings, but not of a noticeably inquiring mind.

[1] p. 38.

How much did these men, in whose hands rested the ultimate authority in the management of Atlantic Acceptance Corporation, know about the activities of C. P. Morgan outside his sphere of responsibility as president of the company? Christie and Gregory and Medland were in a position to know something, but it is apparent that none of the directors appreciated their significance. The most obvious reason for this was Morgan's determination to conceal these activities, come what might; indeed it was essential to his continued liberty of action that he should do so. Everyone who associated with him agreed that he was not a man to encourage inquiry, and he had a most effective way of dealing with associates and subordinates who had opinions of their own; he simply retreated into silence, or offered some terse comment which made it clear that his interlocutor should mind his own business. It is easy at this point in time, long after the critical events in the life of Atlantic Acceptance have passed into history, to discount the effectiveness of this treatment, and to suggest that it should have on occasion provoked vigorous opposition to his management, but two things must be borne in mind. In the first place, the proceedings of a board of directors are inevitably highly formalized, so that business may be conducted with decorum and dispatch; if they are not, questions as to the efficiency of the presiding officer and his staff are bound to arise. In the second place, the board of Atlantic was regularly favoured with immaculate financial statements which testified to the effectiveness of the company's management in undeniably persuasive terms. It has been seen that a similar situation prevailed in the board room of British Mortgage & Trust Company, where the deliberations of the directors under the magisterial eye of W. H. Gregory were only perfunctory, however elaborately documented. In the case of both companies the management had the entire confidence of the directors, and the figures which the former produced were of the most encouraging kind; in addition, the directors of both companies appear to have felt that their officers were supported by competent and highly qualified staff who thoroughly understood the business they were engaged in. In neither case was this entirely true.

Alan T. Christie had been a director of Atlantic since March 17, 1960. In addition to being president of Great Northern Capital Corporation and representative of a dominant and finally preponderant interest in the shareholdings of the company, he was its acknowledged financial expert, and responsible among the Lambert partners for seeing that Atlantic was able to raise the funds it required in the American market; it was through him, for instance, that Kuhn, Loeb & Co. became its fiscal agents for this purpose. Thus he saw Morgan more frequently in the way of business than most of the other directors, and it was he, through the introduction of Carman King, who had first brought Morgan into the Lambert fold. It has been seen that as an investor in Commodore Sales

Acceptance, at a time when Atlantic Acceptance held a 51% interest in that company and before Atlantic's acquisition of the remaining 49% on terms highly advantageous to the minority shareholders, he was in a position to appreciate Morgan's elastic views on conflict of interest. It should be said again that Christie did not profit to the same extent as the rest of the clients of the Annett firm, and did not know that Morgan himself had made the carefully-concealed profit described in Chapter V,[2] but he was himself a director of both Atlantic Acceptance and Commodore Sales Acceptance at the time when the minority interest was acquired, and was aware of the circumstances under which he, Gregory and Wallace were able to profit from the transaction. There and then he gave a hostage to fortune which was never redeemed, and only could have been redeemed by confession that his fiduciary obligation as a director of Atlantic had been disregarded. Thereafter he made his unfortunate investment, again at the suggestion of Carman King, in the convertible debentures of General Spray Service Inc. at a time when that company was being promoted entirely with Atlantic funds, and again found himself in a position where his personal interest as a speculator, and those of the company of which he was a director, were potentially in opposition. On this occasion he knew of Morgan's interest in General Spray Service, and that the fate of that company was in the hands of the man who had sole and unfettered control over the lending of Atlantic funds. Wilfrid Gregory, as already seen, was much closer to being an accomplice of Morgan than any of the other Atlantic directors. His position, and that of his own company, in Aurora Leasing Corporation and N.G.K. Investments gave him special insight into Morgan's methods of operation. Morgan and he communicated frequently, Morgan was on the Toronto advisory board of British Mortgage & Trust, and Gregory's advice to his branch manager at 2200 Yonge Street in connection with the $1,200,000 deposit by the Lucayan Beach Hotel Company, "to get in touch with Powell Morgan and be guided by him", must be regarded as a characteristic opinion when Morgan's affairs impinged on those of the trust company. Medland, like Gregory, sat with Morgan on the board of Commodore Business Machines but, unlike Gregory, had frequent misgivings about the management of that company which Morgan clearly did not share.

### The Loan Committee Question

From time to time excerpts from the evidence given by the Atlantic directors have been quoted in this report, and their evidence must be examined again in relation to some of the questions of particular importance to the welfare of a finance company. Among these the control of

[2] pp. 128-9.

lending bulks very large; and it has already been observed that not only was there no committee of the board entrusted with the supervision of this vital function but no committee of management either, although some perfunctory steps were taken in the direction of establishing the latter by Morgan early in 1965. The question was first raised, as late as May 1964, by Aubrey Medland, who testified about his own part in the matter to the Commission on December 16, 1966.[1]

> "Q. Was there ever any discussion at Board meetings or, to your knowledge, outside Board meetings, of whether it would be in the company's interest to establish a policy that large loans over some figure be approved by the Board and not be made without the approval of more persons than just Mr. Morgan?
> A. Yes.
>
> Q. What discussion was had?
> A. This was a meeting in May, 1964, at the Oakville office of Atlantic Acceptance. I had heard stories about this Racan on the street, and at this particular meeting I asked Mr. Morgan about Racan. I said, 'I have heard rumours; now, is it true or isn't it true?' He said, 'Yes, indeed, this is true', that Atlantic Acceptance had loaned these, and the figures I recall, and I think they are accurate, were $700,000 to Racan, but he went on to say that for this $700,000 we have security of this, that and the other thing up to, he said, what will no doubt realize $400,000. 'Now', he said, 'There is a $300,000 deficiency, and I have a specific reserve against that deficiency.' Then I asked him what other bad accounts there were, if there were any others similar, and his answer was, 'Yes, there are sixteen companies that I am having trouble with', and he mentioned some of them by name, four of them; I believe there was Racan, Treasure Island, Eastgate Motors . . .
>
> Q. General Spray?
> A. General Spray and Phantom Hosiery. Those are the four or five that he mentioned, but then he went on to explain, he said, 'Now, gentlemen, if we were not having some trouble with these accounts we would not be in business, because the reason they have come to us instead of the banks is that it is riskier; that is the reason we get twelve or fifteen per cent instead of five per cent. That is the first thing to remember, and the next thing to remember is that our reserve of two per cent of accounts receivable for bad debts is more than adequate to cover any losses we are going to sustain on these things.' So the discussion went on. Now, I suggested, 'Well, nevertheless, would it not be prudent that we would have an arrangement that any loans over $250,000 would be approved by the directors', and not a word was spoken.
>
> Q. Do you mean literally that observation just fell into a pool of silence?
> A. As I recall it fell into a pool of silence."

[1]Evidence Volume 92, pp. 12466-8.

After an uneasy interval, discussion was evidently resumed on other points. Christie, whose recollection of this meeting, when he took away a handwritten memorandum of four doubtful loans, has already been quoted in Chapter XIV,[2] developed his position in the matter at some length before the Commission, in answer to Mr. Shepherd's questions, on December 15, 1966.[3]

> "Q. There has been evidence to the effect that there was no investment committee established by the Board of Directors charged with the responsibility of passing upon loans over some amount which the Board considered high. Is that correct?
>
> A. That is correct. There was no such committee.
>
> Q. What was the whole discussion, if there was any, about the desirability of the establishment of such a committee?
>
> A. There was discussion from time to time as to the desirability of a loan committee. I think that some people thought of it in terms of a directors' loan committee, and others in terms of a management loan committee. It was my belief, and here again I stress that this to my knowledge was never a question of the propriety of loans, but the business judgment of loans; the Board as constituted was not, in my opinion, made up of people experienced in this field. If such a committee was to be set up on the Board, the Board should have been constituted with different people, and, in addition, the treatment in that manner rather than a management committee, would have slowed down materially the operations of the company. It was, I think, the belief of a number of us that when there were additional officers brought into the company, which we stressed to have done, that this was being done with other members on the committee. In fact, I now find that it was not. We had been, some years ago, worried that there should have been some depth of management, primarily because of the possibilities of illness or death or something of that sort, and we had stressed for additional officers to be employed. They were employed, but as it turns out I am told that they did not function in the capacity of passing on loans; but there was never any controversy to my knowledge on this problem. To some extent I think this may have been common policy in other finance companies, up until the time of Atlantic's trouble, as has been evidenced by actions that have been taken by other finance companies who have now found that they had to make substantial write-offs and things of that sort that their Boards apparently did not know about.
>
> Q. Can you explain more fully why you considered that the Board which Atlantic had could not readily have supplied an investment committee to pass upon loans over some large figure, let us say $200,000 or $500,000?
>
> A. The Board had, I suppose, three people located in Toronto, who were not, in my opinion, finance company type of operators. It is true

[2] p. 861.
[3] Evidence Volume 91, pp. 12360-4.

that now you can say: Well, they would have been better than what we had, but I think that were we moving towards that goal, the procedure would have been to hire additional senior officers, one or two, who would join the Board and would be on hand for this type of operation. But it was decided, to the extent decisions were made, I think by the fact that with the operation we had it was not a practical or practicable thing to operate—and here again we were never motivated by a doubt about the soundness of the decisions that were being made.

Q. Did you consider the advisability of laying down a policy that loans over a certain amount, let us say $200,000, would be approved by a committee of officers of the company and then submitted to the Board for its approval in such circumstances that the Board could rely on the certificate of these officers?
A. I recall no such decisions.

Q. As a man with a banking background, did it trouble you that Mr. Morgan had unlimited power, or that any one man had unlimited power to make loans without any regard to amount?
A. No, it did not trouble me. This is the sort of thing where it is hard to throw yourself back eighteen months, certainly these eighteen months. We did think, or I thought that decisions were being made in committee with the other officers, which I found out after they were not being made.

Q. By 'the other officers' you mean Mr. Sherrill, Mr. McLeish and so on?
A. Yes, when they were brought in. We pressed to get depth in management for assistance in this area, and had we had experience, even in a minor way, of major losses reported, it might have brought this home, but, as you know, these losses were not charged, so that it never appeared that we had them. We innumerable times checked on the loss ratios, and the loss ratios as reported to us were well within the reserve allocations, and we were told, and the facts were passed on to the institutional investors that they were in line with or better than other finance companies doing the same job. It certainly would have been the case in my thinking that if you had had a shock of something of importance coming up as the loan that was charged off, it would have precipitated this. Here again, I am just wondering just how generally this was a policy in the industry because, as I have mentioned, we do find there are other finance companies who have found they had to make heavy write-offs since June of 1965, and I am quite sure their Boards were very much in the same position we were, and would never have allowed this to happen, and were never conscious that it was existing. It was apparently a question of failing to accept losses that should have been written off.

Q. When you say that you believed that large loans were being approved by a committee of management, do you say that because you had the reasonable expectation that anything so rational would in fact be being done, or do you say that because the Board specifically laid down a policy?
A. The former, not the latter. The Board did not lay down that.

Q. One assumed that large loans were not being made?

A. When we talked about getting depth of management, it was brought in for this purpose, and I considered that it was done.

Q. So far as the formal declared policy of the Board was concerned, I take it that no limitation was imposed upon the president as to the exercise of his discretion in making loans of any kind?

A. That is correct, and we were not informed of substantial ones, which would have been the red light to us that this should not be done."

Gregory, according to his own evidence, was not present at this meeting on May 22, 1964, which was one of the very few which took place at the company's head offices in Oakville, but his presence was recorded in the minutes.[4] His testimony on the subject of a loan committee was given to the Commission considerably later, on April 26, 1967.[5]

"Q. The evidence before the Commission is to the effect that the company policy of Atlantic permitted, or at least did not inhibit Mr. Morgan from making whatsoever loans on behalf of Atlantic he wished to make without the intervention of a loan committee or investment committee or a committee of directors. Is that correct?

A. Yes. He had very wide discretion.

Q. Was there ever any discussion among directors about whether it would be desirable that loans over a certain limit, say a quarter of a million dollars, would require approval of more persons than Mr. Morgan?

A. Well, there wasn't, as I recall, but, as a matter of fact, I was coming close to that position myself. But, I just wanted to mention this: I had been on the board of companies which seemed to be similar to this before, where they were completely controlled, absolutely controlled from the United States. When you are a director of that kind of a company you haven't too much to say. They want you to represent Canada, it has been in all the papers; they want you to try and help the company, they want you to express your opinion; but I have found that the decisions are pretty well made. And I just was startled when I found out finally that Christie did not have his own loan committee, or something of this sort, going over every detail, checking the books, when they came up to directors' meetings and just through the management end of it. This is what I was counting on to quite an extent, these circumstances, which apparently was lacking; and I am sure Mr. Mansur must have been doing some of this when he was there.

Q. Do I understand you to say you thought there was a loan committee passing on large loans?

A. No, I didn't think that.

[4] Exhibit 26.
[5] Evidence Volume 115, pp. 15569-72.

Q. I misunderstood you.

A. No, I felt Christie would have his own management committee checking so that he would know, as the owner of the company, what they were doing.

Q. You relied on Mr. Christie in that respect?

A. I relied on the fact that this company was owned by another company, and my experience has been that the parent company checks through the management procedure loans of their subsidiaries. This is why I wasn't surprised that there wasn't a loan committee of the directors.

Q. Mr. Medland testified that he once suggested at a directors' meeting that there should be a committee established to pass upon loans over an amount to be fixed, and I believe he suggested a quarter of a million dollars. Were you at that meeting?

A. I don't recall being at that meeting. I certainly would have supported him if I was.

Q. You said you were about to take a position dealing with the installation of a loan committee. About when had you come to that conclusion?

A. Well, it was pretty near the end. After some of these things at the beginning of 1965 I was going to mention to Alan Christie the next time he came along and we got together. This is the sort of thing you had to do; you don't make an issue of it. I was going to bring up with him whether he didn't think there should be some more control.

Q. Why didn't you?

A. Because I never had an opportunity, we were never together.

Q. There was the annual meeting in June?

A. Yes, but as you know, you come and go and there isn't opportunity. If you make a point of it, I suppose it could have been done.

Q. Why did you feel there should be a loan committee, having held the view Mr. Christie was checking on these things?

A. Because some of these matters as I say, in 1965, when there were doubts in my mind that I never had before."

This was the testimony of one director who had some knowledge and experience of lending money and who, as Medland said, seemed to know a good deal about interest rates and allied matters. The executive committee of British Mortgage & Trust could well have been a model for Atlantic Acceptance, but, as already observed in Chapter XV, the president of the trust company was not above concealing the real nature of large loans, made to individual borrowers, from his own directors, and he was not likely to have broken a lance with C. P. Morgan on this issue.

There remains to be seen what the remaining directors, of the seven

examined, had to say on the subject. William H. Wallace testified as follows to the Commission on December 13, 1966:[6]

"Q. Was consideration ever given at the Board meetings which you did attend to the question of whether an investment committee should be established to approve loans over a certain minimum?

A. I have no recollection of that ever having come up.

Q. Was there ever any discussion so far as you were aware about whether an executive committee should be elected from the Board?

A. No.

Q. Who did you consider was watching over the company among the Board of Directors?

A. Well, I felt that Mr. Morgan—I had never seen or heard anything that would lead me to believe that he wasn't a competent operating executive.

Q. Yes?

A. I knew that Great Northern Capital, Mr. Christie and his partners, had a substantial investment in the company, and through Great Northern and—but they were probably in close touch with company operations, what was going on. We had what I consider to be a competent auditor, auditing firm, and Mr. Allan Beatty, the legal counsel for the company attended on a number of the meetings that I was at—

Q. Yes?

A. —and I had a feeling that those people were in reasonably close touch with the operation of the business in general.

Q. Among all the directors was there any one or were there any two whom you particularly looked to, assuming that they were in close contact with what was being done?

A. Well, I had a feeling that Mr. Christie probably occupied that position, but—I thought maybe some of the directors who lived in Toronto could have—might have had a closer relationship with the actual company operation, but that's purely an assumption on my part. I really had nothing on which to make a statement to that effect.

Q. Is there any particular reason why you did not direct your attention to the question of whether or not there should be an investment committee approving large loans?

A. There is—I had—it was quite a surprise to me to learn after the— and this knowledge only became evident to me after the time of the default.

Q. Yes?

A. Prior to that, from my association, what had—the contacts I had with the operation itself, I was surprised to learn that the company was in the

[6]Evidence Volume 90, pp. 12173-7.

habit of making large industrial loans. I thought that Atlantic Acceptance Corporation was in the business of making small or moderate sized loans, and this was quite a shock to me to learn that these large industrial loans were involved in—I had no knowledge of that.

Q. I take it then that at least at the meetings which you attended there was never any discussion respecting the advisability or otherwise of Atlantic lending large sums to individual borrowers?

A. It seemed to me to be almost axiomatic that if such a thing was presented to them, to management, whereby some corporation would want to borrow some quite substantial amount of money, we will say half a million dollars or even more, that it would have been brought to the attention of the Board to have approval given for loans of that kind.

Walter H. Martin, who recalled the early days of Atlantic when he played a more active part than later, when the company was believed to be firmly in the hands of the Lambert interests, said that, at first, the directors, consisting of Morgan, Bastedo, Firth, Lindley and himself, had always passed upon new loans of any size, then chiefly made to automobile dealers. When the same question about a later discussion on the advisability of having a loan committee was put to him, his recollection of Morgan's reaction was specific.[7]

"A. . . . The discussion of having the directors approve a loan was fairly vigorous at one time, and Morgan made the statement, as I recall it, that Wallace in Montreal, and he travelled from the Atlantic to the Pacific and over the country, and Christie in New York and Gregory in London, he was going to be hamstrung if he had to get the approval of the directors.

Q. Yes?

A. And then one director, I think it may have been Mr. Medland, said 'Well, what about an advisory committee or an executive committee'. Something. I am not sure now, that I didn't suggest the executive committee, but somebody that Morgan could contact in a relatively short time if he had to act fast.

Q. Yes?

A. And this would be proposed to consist of those directors who were in Toronto.

Q. And what came of that suggestion?

A. I don't recall whether it was ever put into practice or not. Whether he contacted Medland or Rooney or those people who were in Toronto, or not.

Q. I put to you, in fact, it was not. I wonder if you could remember, what if anything, was decided to be done or whether there was any discussion about the idea after it was put forward?

[7]Evidence Volume 90, pp. 12286-7.

A. I had the impression that on any major thing Mr. Morgan would consult those directors that were in Toronto, but I am not definitely sure that such a body was elected as an entity."

Rooney's evidence was also given on December 13, 1966, and he dealt with the subject of the loan committee briefly as follows:[8]

"MR. SHEPHERD: Apart from the question of auditors, Mr. Rooney, did the question ever arise as to whether it would be desirable to have an investment committee which would pass upon loans above a certain amount?

A. Yes, this was discussed on a number of occasions, but the instance that I recall most was, I believe, the last directors' meeting which I attended.

Q. This would be May of '64?

A. It would be May of '64.

Q. Yes?

A. And at that time there was considerable discussion on the point, and I believe the consensus of opinion at that meeting was that this was something that should be looked into to try to find a formula or level that may be a different level under different circumstances at which the management could not go beyond and larger loans would have to be referred to this committee.

Q. Who raised the question in the first place?

A. I believe the person most vocal on that occasion was Mr. Medland.

Q. And what position did the other directors, so far as you remember them, take?

A. I had the feeling that it was the complete, one hundred per cent consensus of opinion that this would be a good thing to do."

Rooney went on to deal with another subject illustrating the lack of information either available to or required by members of the board. This was the status and function of the Adelaide Street subsidiaries of which they were all directors by virtue of their total ownership by Atlantic Acceptance. Davidson, as secretary of these companies, testified that at the conclusion of a meeting of the Atlantic board he simply passed around the necessary resolutions and minutes for signature, and the business of these subsidiary companies was attended to as an afterthought in a matter of ten minutes. In general, Rooney confirmed this procedure as the following evidence shows:[9]

"MR. SHEPHERD: Mr. Rooney, you are recorded as being a director of Commodore Factors Limited, having been elected approximately at

[8]Evidence Volume 90, pp. 12242-3.
[9]Evidence Volume 90, pp. 12245-9.

the time that company was incorporated, and remaining a director until after the collapse. Did you have knowledge of the fact that you were a director?

A. Yes.

Q. Did that company have any meetings?

A. I am sure they had some meetings, but as it occurred in a lot of instances—and this I think became more of a practice in the last three or four years—the subsidiaries would have a blanket resolution, and so we had to pass the usual corporate things, approve the statement, the shareholders would elect the directors and then the directors would elect the officers. This was often done on a blanket basis, that is they would pass the statutory resolution and then elect the same directors and officers. This got to be quite common. I do believe there were some, but I cannot recall any specific occasion.

Q. Commodore Factors was an American company. Is it possible that that company followed the American practice of typing its regular statutory resolutions and sending them out to the directors, who would sign them and send them back?

A. With Commodore Factors, in my recollection, this was always the case.

Q. Then your remarks about an informal observation respecting the need to enact the usual resolutions were directed to Commodore Sales and Adelaide Acceptance?

A. Yes, and Pay As You Learn and Atlantic Finance.

Q. Did you receive separate statements of those companies in your capacity as a director of those companies?

A. They came to the office, so that they were always available to me, and my recollection would be that I did go through them, or should have, but I believe in all cases I went through them.

Q. Then let us take the case of Commodore Sales Acceptance. What did you think it was doing?

A. Commodore Sales Acceptance, for the most part—my understanding was that it was in the factoring business, loaning against inventory and receivables.

Q. The sums involved grew to be very significant, did they not?

A. That is right.

Q. Did you feel any concern about the amount of money with which that company was dealing?

A. I directed my attention specifically to Commodore Typewriters, I believe it was, and that loan at times did get up in the order of a couple of million dollars, but discussing it, we always felt quite sure with the American Express bonded warehouse receipts as security and the receivables of the vendors of the typewriters that the security was satisfactory.

Q. Did you believe that the loans to Commodore Business Machines were being made against the security of receivables and inventory represented by warehouse receipts?

A. That is correct.

Q. How did you learn of the amount when you wanted to know what it was, of the Commodore Business Machines loan?

A. The first time I realized it was as high as I think in the order of $2,000,000 was when, by some means or other, I saw Commodore Business Machines—I guess they changed their name to Commodore Business Machines—financial statements when they were first published.

Q. Would this be in connection with a prospectus perhaps?

A. It could have been, yes.

Q. And then seeing the size of the loans, what did you do?

A. I don't know. I think that I would have talked to Powell Morgan and to Allen Christie, but I could not say I definitely did, but I think this would be my usual routine.

Q. Apart from Commodore Business Machines, were you aware of any other large loans made by Atlantic?

A. The only other that I can recall was General Spray, which we understood was having certain difficulties, and another one which was recalled to my memory was Treasure Island. It was accepted that General Spray was in difficulty, but Powell Morgan thought that it would work its way out; and in the case of Treasure Island my understanding was that that was a mortgage on a new building, it was a construction loan which would be paid off with a long-term mortgage within a reasonable time.

Q. Was this discussion held at a directors' meeting?

A. In the case of the Treasure Island and General Spray, I think the specific accounts were discussed at a directors' meeting, the one that we referred to earlier in May of 1964.

Q. Was this in consequence of some questions directed by Mr. Medland as to whether or not there were any large loans in difficulty?

A. That is right.

Q. Did you know at that time who owned General Spray or General Lawn Spray?

A. No.

Q. You were not aware, I take it, of any interest in any of the companies in the General Spray complex of directors of Atlantic?

A. No, I knew none.

Q. And when did you first learn of the existence of any such interest?

A. Well, it was last night.

Q. Was Racan discussed—Racan Photo-Copy?

A. I do not think Racan was discussed, although the name at times did come up, and I recall saying, "Well, I think there is some confusion here, because it is Arcan". Powell Morgan's name had been in the papers, so that I never realized until this inquiry started that Racan was a borrower.

Q. And when the name did come up, if it did, you thought that perhaps the person using it was referring to Arcan?

A. Yes, right."

It will be recalled that Rooney had been interested in the function of Commodore Sales Acceptance as a factoring lender to Commodore Business Machines, or Commodore Portable Typewriter as it was called in the beginning, and had accompanied Morgan to look at the premises leased by Tramiel and Kapp for the transaction of their business of reconditioning used typewriters; his interest in the loan to that company was accordingly natural enough.

The question of the loan committee has been selected as an example. It would have been just as easy to compile a concordance of the directors' evidence on the subject of their knowledge of large delinquent loans, but this has already been commented on and it is clear that at the Oakville meeting in May, 1964 they were given names of only a few of these, with quite misleading figures in connection with them; part of the explanation was, of course, that technically speaking, and because of the device of capitalizing arrears, most of the improvident loans with which this report has dealt at great length could be described as in good standing. All the directors testified to the reassuring statements made by Morgan about Atlantic's allowances for bad debts; he was careful not to draw any distinction between the reserves of the Oakville companies in this respect and those of the Adelaide Street subsidiaries. Morgan continually said that, both as to delinquency and the reserve for bad debts, Atlantic's experience and policy were more conservative than the average for the industry, and with this assurance they were not unnaturally content. The much discussed question of the change of auditors, from Wright, Erickson, Lee & Macdonald to the larger and more widely-distributed firm of Deloitte, Plender, Haskins & Sells, was also clearly recalled by all the directors, who testified to their belief that this change carried with it an engagement to audit the accounts of all the subsidiary companies.

It is clear that C. P. Morgan easily dominated his colleagues, handling the agenda of the meetings with efficiency, dispatch and good humour and, with his ability to produce figures out of his head and relate them to the topics under discussion, effectively forestalled the more searching inquiries which must have followed had he shown any degree

of ineptitude or hesitation. Most of the business considered by the directors dealt with the problem of borrowing, a field in which Morgan, always closely in touch with the money market, was well able to display his virtuosity. Periodic issues of notes required the attendance of representatives of the company's solicitors, Messrs. Osler, Hoskin & Harcourt and the adoption of lengthy resolutions; in the midst of all this preoccupation with the raising of money the more important problems connected with lending it prudently and profitably appear to have been overlooked. All in all, the Atlantic directors seem to have been unusually inadequate as formulators of policy and guardians of shareholders' interests in the complicated and potentially hazardous operations of a finance company, and they had not among their number, as "internal" directors, any of the senior employees who had intimate knowledge of its day-to-day procedures. A heavy responsibility must lie upon the shoulders of Alan Christie for reposing such uncritical confidence not only in Morgan's knowledge of the business itself, which was by no means as detailed as it appeared to be, but also in his standards of business morality which he had some reason to know were elastic.

## Duty of the Directors

During the whole period with which this report is concerned the obligations and liabilities of the directors of Atlantic Acceptance were such as the courts and, to a more limited extent, the legislature have imposed over many years without noticeable change. Directors were agents of their company and not of the shareholders who elected them. At the same time their obligation to the company, though fiduciary, was not that of a trustee, although from time to time the courts may have drawn the analogy of trusteeship in relation to the handling by directors of company funds; none the less the assets of a company are not vested in directors as in a trustee, and they have no obligation to preserve them as has a trustee for the beneficiary of a trust. As long as directors acted in good faith they might take risks with their company's assets in order to achieve its recognized purpose of making a profit. Directors, under the law as it prevailed, were liable for negligence, although here again the duty of care which they were bound to exercise was owed to the company, and, except as it was laid down by statute, was often difficult to establish. A director of a finance company, for instance, is not obliged to know anything about finance, but he must take reasonable care acting on behalf of his company, or such care as an ordinary man might be expected to take in the circumstances on his own behalf. Liability for gross, or culpable negligence has from time to time been imported into judicial decisions, but the difficulty of characterizing failure to perform a duty in such terms is now widely recognized. What Romer J. (as he

then was) found in the well-known case of the *City Equitable Fire Insurance Company*[1] to be the effect of the reported cases at that time, and which may yet be regarded as the law today, subject to additional comment below, was stated in three general propositions as follows:

> "(1) A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience. A director of a life insurance company, for instance, does not guarantee that he has the skill of an actuary or of a physician. In the words of Lindley M.R.: 'If directors act within their powers, if they act with such care as is reasonably to be expected from them, having regard to their knowledge and experience, and if they act honestly for the benefit of the company they represent, they discharge both their equitable as well as their legal duty to the company.'* It is perhaps only another way of stating the same proposition to say that directors are not liable for mere errors of judgment.
>
> (2) A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happens to be placed. He is not, however, bound to attend all such meetings, though he ought to attend, whenever, in the circumstances, he is reasonably able to do so.
>
> (3) In respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly."

Where, however, a director is in breach of the duty laid upon him by statute, his liability may be considered absolute and penalties inflicted in accordance with it. In some cases a statute provides for the liability of a director to the company, an example of which may be taken from the Corporations Act of Ontario:

> "61(3) The directors shall not declare and the company shall not pay any dividend or bonus when the company is insolvent, or any dividend or bonus the payment of which renders the company insolvent or that diminishes its capital, and, if any dividend or bonus is declared and paid contrary to this subsection, the directors are jointly and severally liable to the company for the amount of the dividend so declared and paid or such part thereof as renders the company insolvent or diminishes its capital."

From the conclusions reached in the preceding chapter it would appear that dividends authorized by the directors of Atlantic Acceptance in 1965 were fixed in contravention of this section. It would probably be open to them to say in their own defence that they had relied on the

[1](1925) Ch. 407, 428.
*See Lagunas Nitrate Co. v. Lagunas Syndicate ((1899) 2.Ch. 392, 435)

officers and auditors of the company when they laid the balance sheet for December 31, 1964 before the annual meeting of shareholders, and that they had neither knowledge nor the means of knowledge of the company's insolvency, or any consequential impairment of its capital, as a result of authorizing the dividends declared.

**Proposed Legislative Change in Ontario**

If, however, the Business Corporations Act 1968, already referred to in Chapter XVI, becomes law in its present form, a very different situation will prevail. Section 131 of this Bill reads as follows:

> "131. Every director and officer of a corporation shall exercise the powers and discharge the duties of his office honestly, in good faith and in the best interests of the corporation, and in connection therewith shall exercise the degree of care, diligence and skill that a reasonably prudent director or officer would exercise in comparable circumstances."

The duty to act "in the best interests of the corporation" must be considered an addition to the existing obligations of directors of far-reaching significance when it is read in conjunction with section 87.

> "87.—(1) Subject to subsection 2, a shareholder of a corporation may maintain an action in a representative capacity for himself and all other shareholders of the corporation suing for and on behalf of the corporation to enforce any right, duty or obligation owed to the corporation under this Act or under any other statute or rule of law or equity that could be enforced by the corporation itself, or to obtain damages for any breach of any such right, duty or obligation.
>
> (2) An action under subsection 1 shall not be commenced until the shareholder has obtained an order of the court permitting the shareholder to commence the action.
>
> (3) A shareholder may apply *ex parte* to the court for an order referred to in subsection 2, and, if the court is satisfied that,
>
> (a) the shareholder was a shareholder of the corporation at the time of the transaction or other event giving rise to the cause of action;
>
> (b) the shareholder has made reasonable efforts to cause the corporation to commence or prosecute diligently the action on its own behalf; and
>
> (c) the shareholder is acting in good faith and it is *prima facie* in the interests of the corporation or its shareholders that the action be commenced,
>
> the court may make the order upon such terms as the court thinks fit, except that the order shall not require the shareholder to give security for costs.
>
> (4) At any time or from time to time while an action commenced under this section is pending, the plaintiff may apply to the court for an

order for the payment to the plaintiff by the corporation of reasonable interim costs, including solicitor's and counsel fees and disbursements, for which interim costs the plaintiff shall be accountable to the corporation if the action is dismissed with costs on final disposition at the trial or on appeal.

(5) An action commenced under this section shall be tried by the court and its judgment or order in the cause, unless the action is dismissed with costs, may include a provision that the reasonable costs of the action are payable to the plaintiff by the corporation or other defendants taxed as between a solicitor and his own client.

(6) An action commenced under this section shall not be discontinued, settled or dismissed for want of prosecution without the approval of the court and, if the court determines that the interests of the shareholders or any class thereof may be substantially affected by such discontinuance, settlement or dismissal, the court, in its discretion, may direct that notice in manner, form and content satisfactory to the court shall be given, at the expense of the corporation or any other party to the action as the court directs, to the shareholders or class thereof whose interests the court determines will be so affected. *New.*"

Since a director under the proposed enactment is bound to act in the best interests of the corporation, and since a shareholder under subsection 1 of section 87 may sue to obtain damages for breach of any duty or obligation, it seems clear that, subject to the approval of the court, the latter is in a position to bring an action for damages arising out of a mere mistake of judgment. If it is said that the provisions of subsection 3 give adequate protection to a director, it may be pertinently asked how the court may be properly advised as to the shareholder's good faith, and his reasonable efforts to cause the corporation to commence the action he seeks to bring, if it is deprived of the information and advice that would be forthcoming were the motion for leave only returnable after due notice to the intended defendant, and indeed to the corporation itself, rather than launched *ex parte*. Moreover, once a judge considers himself satisfied as to the good faith of the intended plaintiff, and the desirability of the action being brought in the interests of the corporation as a result of the unilateral representations made by or on behalf of the former, he is deprived of the power of ensuring that such a plaintiff is financially responsible by ordering security for costs; for, indeed, the essence of the section is that the corporation itself shall bear all the burden of the interim costs, and, if the action succeeds, that the defendant shall pay the plaintiff's costs, taxed on the heaviest and most comprehensive scale allowable, "as between a solicitor and his own client". Without dwelling any further on the possibilities raised for vexatious and extortionate proceedings by this bill, it is easy to see that, if it is enacted into law, company directors in the future will be much more vulnerable than in the

past, especially when it is borne in mind that, by section 134, if such an action succeeds a director cannot be indemnified by the corporation "in respect of any costs, charges or expenses" that he incurs as a result; and this must be deemed to include payment by the corporation on his behalf of the cost of any insurance against the risks of a successful suit. It can only be hoped, in the interests of securing the services of competent business men to act as directors, that a judge will be allowed, before proceeding with such an *ex parte* application, to order that notice be given, at least to the intended defendant, before argument is heard and an order made.

Before leaving this digression about the important changes in the existing law contemplated by the bill, the salutary provisions of section 169 should be briefly considered.

> "169.—(1) The directors of a corporation that is offering its securities to the public shall appoint from among their number a committee to be known as the audit committee to be composed of not fewer than three directors, of whom a majority shall not be officers of the corporation or of an affiliate of the corporation.
>
> (2) The corporation shall submit the financial statement to the audit committee for its review, and the financial statement shall thereafter be approved by the board of directors, such approval to be evidenced by the signature at the foot of the balance sheet by two of the directors duly authorized to sign, and the auditor's report shall be attached to or accompany the financial statement.
>
> (3) The auditor has the right to appear before and be heard at any meeting of the audit committee and shall appear before the audit committee when required to do so by the committee. *New*."

The provision of an audit committee, bringing a company's auditors and its directors into closer contact than heretofore, and acquainting the latter with auditing problems which would otherwise be disposed of by the internal management of a company, can only have beneficial results in the future, assuming that any director can be persuaded to serve on it. A thorough understanding of accounting problems and auditing procedures has not hitherto been considered one of the required accomplishments of company directors, and it is more than ever necessary that it should be so. If this provision had been in effect during the period with which this report is concerned, it is probable that the story of Atlantic Acceptance would have been different, and it is certain that the significance of the subsidiary companies, audited by Walton, Wagman & Co. and Wagman, Fruitman & Lando, would have been brought to the attention of those directors composing the audit committee, and by them to the entire board. Scrutiny of a kind which Morgan always took pains to avoid would have occurred not only at the end of the fiscal year but from time to time throughout its course, particularly during the period of the

audit, and the problems inherent in having no contact between the auditors of the consolidated accounts and those of certain subsidiary companies, vital to the performance of the whole group of companies, would not have been overlooked as in fact they were.

The solution in the case of finance companies, if no other, would appear to be the enactment of legislation, peculiar to their needs and designed to protect the public, of the type now provided by the Loan and Trust Corporations Act in Ontario, and by the Loan Companies Act and the Trust Companies Act in the federal jurisdiction. On this subject more must be said; but in concluding these observations as to C. P. Morgan's relationship with his fellow directors it may be fair to say that the record shows they were not entirely supine, that from time to time they made pertinent inquiries, easily deflected by their apparently accomplished colleague who presided over the company's affairs, and that they had no knowledge and little cause to suspect that he was pursuing criminal purposes for his own enrichment, at their expense and that of the other shareholders who had elected them. It is also fair to say that they were not particularly sensitive to the dangers involved in problems of conflict of interest, and that their attitude towards the acquisition by Atlantic of the minority interest in Commodore Sales Acceptance, its own creature, in circumstances under which Christie, Gregory and Wallace profited personally and openly, and Morgan personally and secretly, in the spring of 1961, is an example of this.

### The Guilty Knowledge of C. P. Morgan

After the default of Atlantic Acceptance Morgan made no secret of his belief that he would eventually go to prison for the part he had played in procuring its downfall; he implied as much to Sheeline after his first outwardly confident proposal to "ride in the whirlwind and direct the storm" had been punctured by the inquisition of that astute lawyer, finally aroused by the dangers to himself and his partners besetting them from every side. Yet Morgan, who had never lacked energy or courage, however deficient in principle, could take some comfort from the fact that the extent of his delinquency was deeply buried in the most complex transactions, sedulously concealed and difficult to unravel. He correctly judged that his own services would be required by the receiver and manager, at least in the preliminary stages of its work, and as has been described earlier, he regularly attended the public hearings of the Commission until illness forced him to desist.

A strange development, however, occurred in the spring of 1966, just before Morgan gave his last evidence to the Commission on May 2 and 3.[1] According to his passport, found at 11 St. Ives Crescent with the

[1]Evidence Volumes 25-6.

cancelled cheques and other banking documents in February 1967 as previously described,[2] he obtained visas to visit Lebanon and Jordan from the consulates of those countries in Los Angeles, California, on April 5 and April 11, 1966 respectively, and the United Arab Republic and Thailand from their consulates at San Francisco, California, on April 12 and May 26, also in that respective order. The visa for Lebanon provided for a stay of two weeks, valid until October 5, 1966, and that for Jordan for "2 entries", without specifying any length of stay but expressed to be valid until October 11, 1966; the United Arab Republic visa, valid for six months from the date of issue, was "good for one journey for a total stay of three months from the date of arrival", and that of Thailand for a stay of sixty days without mentioning any limitation on its validity. It is significant that, of these four countries, only Thailand had an extradition treaty with Canada, or, to be more precise, one made applicable to Canada but concluded between Thailand and the United Kingdom in 1911, a fact which may not have been generally known, and suspicion of Morgan's activities is heightened by the selection of Los Angeles and San Francisco, rather than Toronto or Ottawa, as sources of permission to visit them. Mrs. Morgan told Detective Smythe that she planned to take her husband on a holiday, and that the visas had been obtained by them in the course of a trip to California; if so, his absence during a substantial part of 1966 would not have been consistent with his expressed intention to assist the trustee and the Commission as long as information was required of him. At the time the visas were granted it must have already been clear that the Clarkson Company had amassed a quantity of information which only required arrangement and analysis to make it deadly, and that the Commission's investigations, as revealed up to that time at its hearings, would be searching and detailed. All these arrangements, which might have preserved for Morgan prolonged immunity from prosecution and imprisonment, were frustrated by fortune, and a heavier forfeit was claimed.

One who had reason to be perplexed and disturbed by the growing furtiveness of Morgan's conduct, and the company he increasingly kept, was his old friend and loyal subordinate, John C. Laidlaw. His evidence, given to Mr. Cartright pursuant to an order made under the Securities Act on January 26, 1967,[3] has been referred to before, and it will be recalled that, because of a family friendship developed between the Morgans and Laidlaws in Burlington before the former moved to Niagara Falls, Morgan persuaded Laidlaw early in 1962 to leave his position as Toronto circulation manager of the *Globe and Mail* and join the Trio company of Chartered Management Consultants (of Canada) Limited, Thereafter Laidlaw served as a director of a number of companies in

[2]Exhibit 3843.
[3]Exhibit 4888.

which Morgan was interested, notably Aurora Leasing Corporation, and actively managed Mavety Film Delivery which was moderately profitable; yet his prime function was as Morgan's confidential agent, working out of the Chartered Management Consultants' office from which he made reports from time to time on companies to which Aurora and the Adelaide Street subsidiaries of Atlantic had made loans, and in this connection he said, "The ones I did report back on I might as well have reported back to the wall for all the attention my report received". He did not find the atmosphere particularly congenial nor Morgan an easy man to work for.

"Q. Mr. Laidlaw, in the three year period in which you were associated with Chartered Management, how would you describe your personal and social relationship, if any, with Mr. Morgan?

A. Businesswise, during that interval Mr. Morgan was a very difficult man to see. His offices were down on Adelaide Street. The only time I would see him during the day time is if he came into Wagman and Walton's office, during which period he would be locked in a room with Mr. Wagman, and Walton in the earlier stages, before their partnership dissolved back in—

Q. I would suggest 1964?

A. I think it was 1963. Just prior to Christmas, 1963.

Q. Right.

A. They would be in conference for an hour, two hours and a half, in a locked room and I wasn't called in. From my observation it was obvious Mr. Morgan had some dealings with those gentlemen, but it was practically impossible for me to talk to Mr. Morgan, businesswise, during the daytime, except possibly by phone. The only opportunity I would have to express my opinion as to the operations and frustrations of my personal job, I would say, was possibly once a month if we got together for dinner or something like that, with our wives. That was about the extent of it.

Q. Yes?

A. I reported back on several people. I think I have two letters on file, but Mr. Morgan wasn't one for putting things on paper, and I don't think he wanted other people to put things on paper, either.

Q. Were you aware, in this three year period, of Mr. Morgan conducting any business activities at his residence?

A. At his residence?

Q. At his residence?

A. Well, Mr. Morgan, on weekends, as I say, the only time I would see Mr. Morgan on weekends, in the limited time we occasionally went up there on Saturday or Sunday, his house was like Grand Central Station

as far as certain individuals coming in to see him and going upstairs to the upstairs den. What transpired up there, I couldn't tell you. I know on a so-called social afternoon, or so-called social evening, he would be in the room twenty minutes at a time and the rest of the time upstairs with Mr. Groship or Mr. Levenson, Mr. Tramiel or Mr. Kapp.

Q. Those gentlemen were all gentlemen known to you at that time as being managers or operators of the companies which were in receipt of large loans from Atlantic subsidiaries?

A. I knew Mr. Levenson borrowed considerable money. I knew Mr. Groship, even prior to my going to Chartered Management, I knew he had borrowed money. As far as Mr. Tramiel and Mr. Kapp, I knew there was some financial transactions between them and Commodore Business Machines.

Q. Over what period of time would these attendances take place at Mr. Morgan's residence? Would it be through 1962, 1963, 1964 and 1965, until the collapse of Atlantic?

A. I would think it would be more to the later stages, but I wouldn't say you could eliminate 1962, but it became more obvious to me during 1963 and 1964, or 1963, 1964 and 1965, up to the time of the collapse.

Q. Do you know, personally, whether Mr. Morgan maintained a desk or any sort of working area in his home?

A. I believe the den had a desk in it.

Q. Do you remember, sir, whether there was any depositories for documents in Mr. Morgan's home, such as a safe, filing cabinets?

A. I couldn't tell you.

Q. I am interested, Mr. Laidlaw, in your overall impression of Mr. Morgan, personally, as we go through 1962, 1963, 1964 and into 1965. Was there any appreciable change in his mannerisms, his character or the way he conducted himself?

A. Well, even at the outset, at the first time I met him, Mr. Morgan could hardly be called an extrovert, as far as his social activities were concerned. He was considered to be a quiet man, but during the last two years I think his disposition and his nature became more on edge. This is just personal observation on my part. I couldn't pin it down and say there was a drastic change, because the nature of the man, initially was very very reserved and quiet, but I do think he became a little more on edge in the latter year and a half I knew him.

Q. Did Mr. Morgan ever reveal to you any of his thoughts that he had about doing business with gentlemen such as Mr. Levenson, Mr. Last, Messrs. Kapp and Tramiel and Mr. Groship?

A. This used to be a tremendous bone of contention with myself. I might not be the smartest person in the world, but I believe I can spot a character when I see one. I couldn't believe my eyes, that the persons

he was doing business with were the type, can we say, I would hesitate to loan them a nickel. I brought this to his attention and his wife's attention on many occasions. I wondered about the firm doing business with that type of person, and Mr. Morgan's answer was that it was the nature of the business. This type of business you are lending money at a high rate of interest and you have to take those risks and deal with people of this nature.

Q. I am interested in his philosophy of doing business. Could you explain that at all, or help me any further?

A. No, I can't. As a matter of fact, he wasn't that divulging in his thoughts. In the earlier stages he was always most optimistic about the future of the operation. For instance, if we get down to the Lucayan Beach affair, and when I asked him who was in charge down there, he mentioned two people, Alan Manus and Lou Chesler. I had heard of Mr. Chesler and I understand—I don't know whether this is going to be —I had heard of Mr. Chesler many years ago and his manipulations in the market, if you want to call it that. I said to Mr. Morgan: 'Why, in God's name, do you want to do business with him for?', and the same thing applied to Mr. Alan Manus. He was always favourable with anybody he did business with. I didn't understand those things. I said: 'Well, you don't go up and kiss a rattle snake,' or this type of thing.

Q. Did Mr. Morgan ever express to you any misgivings? Particularly I would like to direct this question to the month in 1965 prior to the collapse of Atlantic?

A. No, he didn't. I think on one occasion he did state that Mr. Manus had let him down badly, and that is as far as it went."

Laidlaw took over the presidency of Aurora Leasing on September 28, 1962 from Carl M. Solomon who continued as an officer in the position of vice-president. Thereafter the board consisted of Laidlaw, Solomon, Carman G. King, Solomon G. Steinhart and John Canning who was succeeded on June 17, 1963 by Walter Pahn. It was well understod by all of these men who gave evidence to the Commission—and they all did in one form or another with the exception of Steinhart—that Morgan was the source not only of its funds but its policy, and that all of them, with the exception of Steinhart and King, were Morgan's nominees. Laidlaw, however, was uneasy about his responsibilities as president.

"MR. CARTWRIGHT: From your observations in the three year period, can you give me your thoughts or your views as to why the disastrous situation occurred, as it did, on June 15th, 1965?

A. Well, from my limited knowledge of the books of Aurora, they were lending, according to my opinion, good money after bad. In other words, where previous loans and the interest, in some cases, hadn't even been paid, let alone anything on the principal, Mr. Morgan would instruct

> further loans to go to those firms and I became somewhat concerned. I felt if the whole operation was on that level, I was on pretty shaky ground. But on the other hand, I had no idea about Atlantic, itself. This is what Mr. Morgan used to emphasize. These things would be taken over by Atlantic and it was just a drop in the bucket and Atlantic was as strong as the Rock of Gibraltar."

He reverted to the subject again when counsel asked him a comprehensive question at the conclusion of his examination:

> "Q. . . . Is there anything else, sir, that you can tell me, that will assist me as to why Atlantic collapsed in June of 1965?
>
> A. No, I don't believe I can, Mr. Cartwright. As I say, the subsidiary companies, and I had only access to one, or knowledge of one of them, and that was Aurora; it seemed to me, from reports that got back, and you hear other people talking, and when you see people like Mr. Levenson—and in the case of Mr. Levenson, I wanted to go over to Buffalo because I wasn't impressed with him the first time I met him. I wanted to see his operation over there as to why they would require all this money he had borrowed and not paid on it. Mr. Morgan never saw fit to have me go over there. I don't think my appearance at Arcan was particularly welcomed by Mr. Groship. Nor do I think it was welcome at Canada Motor Products during the period that firm stayed in business. It seemed to me, people at the head of these various firms didn't want any outside interference, whatsoever, nor were they anxious to get anyone in there to get a report back to Mr. Morgan as to the way the affairs were being conducted.
>
> It was also quite obvious to me that the people in charge of these firms were living in the lap of luxury, so to speak. They weren't depriving themselves. Most of them had Cadillac cars. Most of them flying here and there and that, in connection with their business activities, I don't know. I could elaborate on other phases of the operation I observed. This is something I reported back to Mr. Morgan, and I think he was fully aware of this, anyway."

Morgan, by the end of 1964, had done much to alienate his oldest associates, and particularly the honest men among them. With David Davidson he was barely on speaking terms and had deprived him of all but the most formal functions as secretary of Atlantic Acceptance and its subsidiary companies, and Davidson had gone so far as to refuse to sign the supplementary information reports to the Atlantic noteholders in that capacity. Aubrey Medland, a staunch supporter of Atlantic in its early days, had become a nuisance because of his persistent attempts to gain information about loans and allowances for bad debts. Morgan sank steadily into the society of people who clung to him because of his respectability and position in the business world, and the seemingly inexhaustible funds at his command. Behind and beneath the splendid outward

structure of Atlantic Acceptance Corporation, with its well-regarded directors, auditors and solicitors, lurked Walton and Wagman, Solomon and Singer, Last, Manus, Groship, Levinson, Rabbiah, Tramiel and Kapp, Frank Kaftel and Donald Reid. Inventive, ingenious, incompetent and corrupt, Morgan, and Morgan alone, drove Atlantic forward to catastrophe and, like all the well-known swindlers of history, he did so with a fatalistic and cynical disregard of those principles of fair and honest dealing which have been generally accepted and adhered to for generations in both the civilized and savage world.

# CHAPTER XIX

## *The Effect of the Atlantic Failure on the Money Market: The Abell Report*

An important section of the Commission's terms of reference required it to investigate, inquire into and report upon the effect of the failure of Atlantic Acceptance Corporation on the money market in the Province of Ontario. Since the money market in Canada knows no provincial boundaries, it may be assumed that the insertion of this limitation was in accordance with constitutional practice, and did not preclude a more extensive inquiry as to the effect on the Canadian money market as a whole with a view to determining its impact upon the financial community in Ontario, and particularly in Toronto where it is generally conceded that the greatest activity occurs. In Chapter I, (p. 27) I have already described how the services of Mr. J. N. Abell, M.A. (Oxon.), now president of Wood, Gundy & Company Incorporated of New York, a subsidiary of the well-known Toronto investment firm known as Wood, Gundy Securities Limited, were obtained by me to prepare a study for the Commission in a field where special knowledge and experience were required. Mr. Abell's qualifications in this respect were universally acknowledged, and his experience with Wood, Gundy & Co. from 1954 onward exactly spans the period of development of this market by the Bank of Canada and the fifteen accredited investment dealers to which it has granted lines of credit to sustain their participation in it. From 1962 to 1966 he was the managing director of another subsidiary company known as Wood, Gundy (International) Limited, and was in the process of transition from that position to his present one in New York when he commenced his study for this Commission early in the latter year. His report to the Commission was completed in October, 1966, and during the course of its

preparation he was given the fullest co-operation in obtaining statistical information by Mr. Louis Rasminsky, C.B.E., Governor of the Bank of Canada, and his staff. The report was not offered in evidence until May 30, 1967,[1] the delay being considered desirable because of the still unsettled state of the finance company industry as a result of the failure of Atlantic Acceptance, and the support which the Bank of Canada and the chartered banks were giving Canadian finance companies to tide them over a period of difficulty in obtaining funds from the type of investor which had been most adversely affected by it. On this occasion Mr. Abell gave evidence about the background of the report, its scope, the investigations on which it was based, and the validity of his conclusions as they applied to the situation prevailing in the spring of 1967. It is desirable to quote some portion of this at length.[2]

"MR. SHEPHERD: Have you on previous occasions given evidence or delivered papers in respect of the money market in Canada?

A. Yes. I was called to give evidence before the Porter Commission.

THE COMMISSIONER: That is the Royal Commission on Banking and Finance?

A. Yes. I have delivered a paper to the National Industrial Conference Board in 1964.

MR. SHEPHERD: On the money market?

A. On the money market.

Q. In respect of your appearance before the Royal Commission on Banking and Finance, on whose behalf did you appear?

A. I was asked as an independent witness and gave verbal evidence at a closed session.

Q. By the Commission itself?

A. Yes. The Commissioner asked me.

Q. In the course of your duties in connection with the money market operations of Wood Gundy, did you have occasion to effect liaison with the Bank of Canada, for example?

A. Yes, I had contact with the bank on money market matters and other institutions such as the Chartered Banks and the major life insurance companies and the large industrial corporations and also trust companies.

Q. What connection has Wood Gundy with the money market in Canada?

A. We would be one of the dealers accredited to the Bank of Canada for money market operations. There would be originally twelve of these dealers. We were one of the original twelve.

[1]Exhibit 4714.

[2]Evidence Volume 124, pp. 16665-71.

Q. Were you retained by this Royal Commission on Atlantic Acceptance to effect a study and prepare a report on the effect on the money market in Ontario of the collapse of Atlantic Acceptance?

A. That is correct.

Q. And did you do so?

A. I did.

Q. Did your study in fact embrace more than the money market in Ontario?

A. Yes. The basis of the report was a brief history of the money market since its inception in Canada, continuing from that to another section which dealt with the position of Atlantic Acceptance and how Atlantic made use of the money market, and a final section on the results to the money market of the failure of Atlantic. That is an outline of the report.

THE COMMISSIONER: With respect to the money market in Ontario, I point out that those words are taken from the letters patent establishing the terms of reference of this Commission. Is it fair to say that it is not feasible to put provincial boundaries on the operations of the money market?

A. No. I think two-thirds of the Canadian money market exists in Ontario, but money flows from other provinces and from outside the country.

MR. SHEPHERD: How long were you engaged in the preparation of your study and report for the Royal Commission?

A. I worked virtually full time over three months and subsequently wrote and corrected a report over the succeeding six months.

Q. What inquiries did you make in connection with the preparation of this report?

A. My initial inquiry was in Canada to collect statistics from the Bank of Canada, from the Dominion Bureau of Statistics and from various other Government sources and with these statistics started a series of consultations and interviews with some forty-eight of the major institutions who were holders of Atlantic paper, initial short-term note holders, until subsequently I visited the United States to see the major U.S. holders of Atlantic paper to give them an opportunity to discuss the matter.

Q. In Canada did you also consult with the chartered banks with a view to determining the effect on them?

A. That is correct, and with the Bank of Canada.

Q. What questions generally were you putting to the American long-term holders?

A. With American long-term holders, I was interested in how they came in contact with the company and with the securities, the rôle of intermediaries such as brokers and dealers, the contact they had had

with the company, and I was interested in the details that they had been given at the time of purchase and whether they had themselves made any internal studies of the credit.

Q. Did you direct your attention as well to the effect of the collapse, insofar as it could be ascertained, on their future operations?
A. Yes, I inquired and in as far as they were able, they gave me their answers to this question.

Q. Did you make inquiries to learn to what extent, if at all, the interest equalization regulations and presidential guidelines, as they are called, had any effect on the availability of moneys to Atlantic Acceptance in the early part of 1965?
A. Yes.

Q. Do you now produce a report headed 'Report on the Money Market Aspects of the Failure of Atlantic Acceptance Corporation' bearing date of August, 1966, comprising seventy-seven pages of text together with eleven tables of statistics?
A. Yes.

Q. And this is the report which you prepared and in the manner you have described?
A. That is correct.

Q. I offer this in evidence.

THE COMMISSIONER: Exhibit 4714.

—*EXHIBIT NO. 4714:* Report headed 'Report on the Money Market Aspects of the Failure of Atlantic Acceptance Corporation'.

MR. SHEPHERD: Now Mr. Abell, the report must speak for itself and certainly I will not trouble you to read it or comment on it in detail, because of its complexity and because of the degree to which it is all-embracing, but perhaps you could state briefly the matters considered in this report. First, did you consider the definition of the money market?
A. Yes. I attempted to outline as simply as possible the definition of the money market and, as I mentioned before, a brief history of how it had come into being in Canada.

Q. Turning to the role of Atlantic Acceptance, did you consider that and its history?
A. That is correct.

Q. And then what does the report deal with?
A. The final part of the report is a review of what happened to the money market as a result of the failure of Atlantic.

Q. Did you consider as well the effort made by various bodies to ameliorate the effect of its collapse?
A. Yes, I did.

Q. This report is dated August, 1966. Have you considered the report recently with a view to deciding whether or not the conclusions stated as valid in August, 1966, respecting the recovery made from the effect of this collapse are still valid?

A. Yes, I have considered it over the past week. I believe that in general the outline as shown in the report is valid at this date.

Q. Speaking generally, the situation as it was in August, 1966, is still substantially the same?

A. The same factors are in force."

Since this evidence was given I have been in touch with the author from time to time, and he has told me that he has no reason to revise the opinions that were expressed in it. A happy recovery in the fortunes of Canadian finance companies has been achieved by their own resolution and determination, in some cases, to make a radical re-assessment of the value of their accounts receivable and the size of the allowance for bad debts necessary for their protection. There have, however, been casualities of the disillusionment caused by the Atlantic failure in many fields of commercial endeavour, and one large Canadian finance company, Alliance Credit Corporation of Montreal, with $100,000,000 in assets and 100 branch offices here and abroad, was forced, first to restrict its operations in 1966, and finally into liquidation in 1967 with no recovery expected for its common shareholders.

Mr. Abell's report together with its schedules and appendices is reproduced below in its entirety as presented to the Commission, and is adopted as it stands as an integral part of the Commission's report. It has already been given some circulation since acquiring its status as an exhibit and has been commented upon in the press.

* * *

## REPORT ON THE MONEY MARKET ASPECTS OF THE FAILURE OF ATLANTIC ACCEPTANCE CORPORATION

by

J. N. ABELL

The money market in Canada has developed rapidly in the past twelve years and is now a very active and competitive part of the capital market.

A description of the Canadian money market must first of all start with an attempt to define what is meant by "money market". It is not a matter that lends itself to exact definition but it can be explained by considering the components of the market. The main components are the Bank of Canada, the chartered banks, the finance companies, the major financial institutions such as the trust and insurance companies, the industrial companies and the various levels of government.

All these diverse components make use of the money market in two main ways, either to invest temporarily surplus funds or to borrow funds.

Active as intermediaries between these major components are the fifteen investment dealers who maintain the money market.

The investment dealers[1] who have money market departments have each been granted lines of credit by the Bank of Canada. These lines of credit were first granted by the Bank of Canada in 1952 after the dealers concerned had demonstrated that they had the necessary capital resources as well as a willingness to participate in and develop an active trading market in money market securities. However, the activity in the market was very small until 1954 when the chartered banks agreed to make "day loans" to the dealers as explained later.

Money market securities are the instruments that are placed and traded in the money market and provide the means by which institutions and corporations, as well as the chartered banks, are able to keep surplus funds invested while still retaining adequate liquidity. These securities normally have a term of under three years but by far the most active market is maintained in Government of Canada bonds, with each money market dealer calling firm markets in these Government securities. At times of activity in the market for Government bonds, many millions of dollars worth of securities will change hands each day. The dealer's profit is made partly from the spread between purchase price and sale price and partly from the profit (although sometimes a loss) made by borrowing money to finance inventory at a cost below the yield available on the inventory.

Communication between the various components in the market is by telephone with the dealers having direct telephone lines between each other and also direct telephone lines to the major institutions. All transactions are made by telephone with the dealers sending out a contract by mail overnight in confirmation. Delivery of the securities traded takes place against payment in from one to three business days, depending on the type of security involved. Many deals are, however, arranged for settlement to take place the same day. This arrangement is nearly always the result of a special request by the buyer at the time the transaction is completed; similarly some transactions are for delayed delivery, with delivery being arranged to take place on a specified date in the future. In either of these cases an adjustment in price above or below quoted market prices is sometimes necessary to allow for the unusual delivery arrangements.

[1]A. E. Ames & Co. Limited, Burns Bros. & Denton Limited, Dominion Securities Corp. Limited, Equitable Securities Canada Limited, Fry & Company Limited, Gairdner & Company Limited, Greenshields Inc., Harris & Partners Limited, McLeod, Young, Weir & Co., Limited, Midland-Osler Securities Limited, Mills, Spence & Co. Limited, Nesbitt, Thomson & Company Limited, James Richardson & Sons, Royal Securities Corp. Limited, Wood, Gundy Securities Limited.

The money market dealers each carry inventory of Government of Canada treasury bills and bonds with less than three years to run to maturity. They obtain the necessary loans for this inventory by borrowing funds, usually on a day loan basis, from the chartered banks or other financial institutions. The fact that the dealer has a line of credit with the Bank of Canada means that should loans not be available from the chartered banks or elsewhere to provide the funds needed to carry his inventory, he can arrange for a loan from the Bank of Canada. The loan from the Bank of Canada is more technically described as a "purchase and resale agreement". These P.R.A.'s are secured by the delivery of the designated securities which may be treasury bills, Government of Canada bonds with less than three years to run and bankers' acceptances.

The Bank of Canada purchases the securities from the dealer against his guarantee to repurchase them from the Bank of Canada within thirty days. However, most purchase and resale agreements are terminated within a very few days.

The chartered banks are aware that these lines of credit exist at the Bank of Canada although the banks are not aware of the individual's line of credit. However, the banks are prepared to lend to the money market dealers on a day loan basis against the same collateral as is acceptable to the Bank of Canada when entering into a P.R.A. with the dealers. The banks rely on the reporting procedure whereby the Bank of Canada requests each money market dealer to report his inventory and loan position each Wednesday. The dealers are not permitted to have day loans from the chartered banks in excess of their line of credit at the Bank of Canada unless prior permission has been obtained from the Bank of Canada.

A day loan has the important characteristic that it may be terminated by either party by word of mouth before noon with settlement being made on the same day. It is this extreme flexibility and the fact that the dealer is in a position to obtain funds at the Bank of Canada in the event sufficient funds are not available elsewhere, that keeps the cost of these loans relatively low. Each chartered bank, by increasing or decreasing the amount of money that it has in day loans, can adjust its cash position very quickly through the facilities provided by the dealers in the money market.

The dealers carry these inventories of Government securities in order to be able to complete the large transactions that may be done in the market from time to time. The dealers are in the money market to make money for themselves and although trading profits are not large it is nearly always possible to buy and hold short-term Government securities yielding more than the cost of the day loan. This involves the taking of considerable risks since the smallest decline in the market can cause a substantial loss when a dealer's inventory may consist of tens of millions of dollars worth of securities. On the other hand, an increase

in the market value is conversely quite profitable. It is a highly competitive market with profit margins appearing to be extremely small when related to volume of business. As a result it is vitally important to the dealer to reduce the cost of loans against securities while at the same time providing as high a standard of service as is possible. This need to reduce borrowing costs encourages the dealer to be active in the market seeking out new sources of short-term funds.

One aspect of the money market which is given some publicity each week is the auction of Government of Canada treasury bills. The auction is managed by the Bank of Canada acting as fiscal agent for the Government. Each Thursday tenders are called for a stated amount of three-month and six-month treasury bills. The money market dealers and the chartered banks are the largest consistent buyers at these weekly auctions, although anybody can submit a bid if they so desire. Unless a public holiday intervenes the treasury bills are paid for and delivered on the Friday following the auction.

After each auction the average yield at which the bills were sold is announced as well as the highest and the lowest bids that were successful. The rate of the three-month treasury bills is considered to be one of the most sensitive indicators available to show the state of the money market.

Until 1958 or early 1959 most of the funds required by the money market dealers to finance their inventories of Government of Canada bonds and treasury bills came from the chartered banks. However, during the period of high interest rates in 1959 this source of supply gradually became less important as dealers turned to non-bank sources for these funds. These non-bank sources have at times accounted for 70% of the funds needed by the dealers, although the average for the past five years is probably below 50%. These lenders are sometimes referred to as "country banks" and include the trust companies, the insurance companies, many large industrial or mining corporations and the sales finance companies, as well as the provincial governments. The dealers have found from experience that these accounts tend to be more predictable in their loans with the result that money borrowed from a country bank is available for a longer period, although the loan is on a demand basis, than is money borrowed on a similar basis from the chartered banks. This fact reflects the different type of liquidity required by a chartered bank to whom the termination of a day loan is the simplest and quickest method of raising funds, compared with the country banks, who are not nearly so subject to such wide swings in their cash requirements and who can more easily anticipate their need for funds.

In recent years there has been a gradual refinement of techniques used in the money market. One example is the so-called "reverse loan"

whereby a dealer will borrow Government of Canada short-term securities from an account for a fee of say ¼ of 1% per annum calculated for the number of days the loan is outstanding. As collateral for this loan the dealer will pledge finance company notes on commercial paper. The dealer can then obtain a loan on a day loan basis against the borrowed government securities. This procedure sounds quite complicated but it can also be profitable. For instance, if the day loan rate is 5% and the rate on thirty day finance company paper is 5½%, the dealer can earn 5½% from the finance paper against which he must pay out ¼ of 1% per annum as a fee to borrow the government bonds and 5% to obtain a day loan. The dealer runs the risk of a change in the day loan rate but if, for the sake of argument, the rate averaged 5% for 30 days his profit on the transaction would be ¼ of 1% per annum plus the commission from the finance company which might be an additional ¼ of 1% per annum. These profits sound small but when large sums of money are being handled they become quite significant to the dealers concerned. In addition this technique can be used to permit the dealer to sell and deliver securities he does not own and it also indirectly provides funds to the finance companies and the industrial companies at a time when their notes might not easily be saleable by any other method.

The above is a brief description of the money market as it exists for Government securities. It is a market that has developed under the active encouragement of the Bank of Canada and it now fulfills an important function in the capital markets. This function has been well described by D. H. Fullerton in his book "The Bond Market in Canada", page 172. "A smoothly functioning money market fulfills a multiplicity of needs. For lenders it provides a means of investment for short periods with little if any risk or loss of liquidity. For borrowers it provides short-term accommodation that may be difficult or more expensive to obtain elsewhere, and it permits a more accurate phasing of cash flow with needs. For government it taps an additional source of funds. Finally, and perhaps most important of all, it is the main mechanism through which the monetary policy of the central bank is carried out." It is for this reason, among others, that the Bank of Canada has been encouraging the growth of an active money market, for it is through its action in the money market as a buyer or seller of Government securities that the Bank of Canada is able to influence yields and also affect indirectly chartered bank liquidity.

Another major facet of the money market is the placement by the dealers, acting as agents, of the short-term notes of the major finance and industrial or commercial companies. This is straight commission business which provides the dealers with an important and consistent part of their money market income.

The money market has other functions besides its main activity of trading in Government of Canada securities. There has developed a

growing market for the short-term notes or treasury bills of the provinces and major municipalities, as well as the parity or savings bonds issued first by British Columbia in 1961, but since that date Quebec, Manitoba, and Saskatchewan have issued smaller amounts of similar instruments. Some of these parity bond issues were limited to residents of the province concerned and rationed as to amounts sold to any one individual. The main feature of all these issues is the fact that the holder can cash the bond at face value at any time, although, as interest is only paid quarterly or semi-annually by the cashing of coupons, most bonds are surrendered for encashment on these dates.

In the late 1950's some provinces and municipalities commenced the issue of short-term bonds with low coupon rates and sold at a discount. These proved popular with corporations who received a tax-free capital gain by holding the bonds to maturity and because of this tax saving the bonds were issued at a lower gross yield, thus saving the issuer some costs. For example at a particular time a province or municipality was able to borrow money for one year at an interest cost of 6%. At the same time, it might be possible to find a corporation or an individual who would prefer to buy, say a bond or note bearing an interest rate of 2% but available at a cost of $97.00 per $100.00 face value. At this price such a note would yield the buyer 5% per annum and would cost the borrower 5% also if we ignore the commission charged by the dealer.

The buyer who, for the sake of argument is in a 50% tax bracket would, under the tax act in force up to December, 1960, have claimed $3.00 per $100.00 as a tax free capital gain and 2% only as taxable income for an after tax yield of 3% plus 1% or 4%. This investment would, therefore, be more attractive to the taxable buyer than a 6% note all the income from which would be taxed at 50% for an after tax yield of only 3%. At the same time the borrower would also have saved 1% in borrowing costs and the only loser would be the tax collector.

This method of borrowing short-term funds by creating notes with smaller interest rates and sold at ever deeper discounts was eventually carried too far and in December, 1960, the federal budget brought in a new provision which effectively limited the yield at which such bonds were issued to ⅓ higher than the coupon rate. This change was designed to limit the use of very low coupons and thus very deep discounts which had had the effect of depriving the Government of revenue through reduction of taxes. From the point of view of the dealers, this new provision was welcomed as it provided some guidance to an area of the market which was suffering from intense competition and varying interpretations of the tax liabilities of the buyers of these deep discount notes.

In 1962 Manitoba and Saskatchewan became the first provinces to issue treasury bills on a regular weekly basis. This was an interesting

experiment and an example of co-operation between two provinces as each province conducted their treasury bill auction in close co-operation with the other. Prior to this date, and to this day, various of the provinces had issued treasury bills for internal purposes but only occasionally had provincial treasury bills been offered to the money market.

Other instruments that are part of the money market but not traded as actively are Bankers' Acceptances, which initially entered the market in 1962 but which have only recently become of any importance, and chartered bank and trust company deposit receipts which have always been important, although recently they have gained still further in amounts outstanding.

The chartered banks first issued term notes in 1960, originally for periods over one year. Recently, however, the banks have begun to issue far more flexible instruments in an effort to attract deposits. These new deposit receipts are available in amounts of $100,000 or over and have proved very successful in attracting deposits. From time to time dealers will purchase such deposit receipts and use the instrument as security for sale and repurchase agreements with the country banks or will use them as collateral for fixed term or demand loans.

The chartered banks have agencies in New York and these agencies have been successful in attracting U.S. funds on fixed term deposits by paying competitive rates. Sometimes funds from Canadian companies are placed in New York with these chartered bank agencies. Normally these funds are placed on so-called "swap deposits". A swap deposit is a deposit made in U.S. dollars but in conjunction with two foreign exchange contracts. The first contract is for the purchase of the necessary U.S. dollars and the second is a contract for the sale on the day the deposit in New York matures of the resulting U.S. dollars including interest to be received. Thus, the investor has a package deal whereby a known amount of Canadian funds is invested and a known amount received back on a stated date. This enables a rate of return to be calculated on the Canadian funds invested and it is this yield which is quoted when a swap deposit is being arranged. The chartered banks arrange these swap deposits through their foreign exchange trading departments although from time to time the money market dealers become involved.

The main area of the market that has now to be considered is the area where the dealers act as agents in the placing of the short-term notes of the finance companies. It is this part of the report that is most directly concerned with the general work of the Commission.

The notes of the major finance companies in Canada such as Industrial Acceptance Corporation, Traders Finance Corporation and General Motors Acceptance Corporation of Canada, to mention only a few, have been issued in Canada for many years but although there was some increase in activity in the 1940's it was not until the money market

started to expand and become more active in 1954 that the amount outstanding began to climb rapidly. In 1951 the amount outstanding was estimated to be $118 million and by 1960 had reached a figure in excess of $550 million but by the end of 1964 the total had increased to $1,150 million. This had become a major part of the money market dealers' business and a profitable one with the finance companies paying a commission of between ⅛ and ⅜ of 1% on that proportion of the paper that was placed by the dealers. Of the total perhaps 15%—20% is now placed directly by the finance companies but of the rest all but a small proportion is placed through the dealers or the chartered banks in the money market with only a few non-money market dealers placing any substantial amount.

At times the dealers will purchase the finance company notes in their own names, but on the whole they work as agents in negotiating the placement of notes with the lenders and also in many cases setting up and sometimes carrying out the delivery of the notes, although more typically the physical delivery will be handled by the finance company or by the finance company's banker if the lender is outside the main financial centres of Montreal and Toronto.

Finance company paper is sold in one of two forms, depending upon the issuer concerned. The Canadian-owned finance companies all issue secured notes where the notes are secured by the company depositing with a trustee or a custodian nominated by the trustee a certain amount of receivables as collateral. This amount is usually between 112½% and 135% of notes outstanding and is certified to by the trustees, usually a trust company. The buyer of the note is given a prospectus, which is updated once a year and contains the trust indenture under which the notes are issued.

The U.S.-owned Canadian finance companies usually issue unsecured notes, being simply a promise to pay and therefore resting on the credit of the corporation, although often guaranteed by the parent company. The buyer of these notes is also provided with a prospectus, which is re-issued each year.

The notes are sold on either a discount basis or an interest-bearing basis, with many of the issuers prepared to issue whichever type of instrument the buyer prefers. Notes issued in Canada have interest calculated on a 365 day year basis whereas by convention notes issued in the United States bear interest calculated on the basis of a year divided into 360 days. Notes are normally issued for periods from 30 days to one year, with the buyer able to select whichever maturity date he desires. In the last two years most finance companies have started to issue notes shorter than 30 days and in fact some notes are as short as three days while others issue notes which give the buyer the right to recall his money at any time without penalty on 24 hours notice. These demand notes are issued to take advantage of the lower rates at which money is

available on these terms. It is an area of the market that was originally developed by the retail, industrial, and grain companies issuing commercial paper but the finance companies are now in this part of the market and appear likely to stay. When the money market was developing the finance companies preferred not to sell very short-term or demand notes as their expenses for issuing a note were quite high, and they preferred the security of knowing that none of the notes they had issued could be terminated without their permission. Therefore, until the money market developed to the point of being able to supply a reasonably constant amount of funds the finance companies left the very short-term money to the commercial paper companies who were able to issue such notes with some confidence as in nearly every instance these companies have and maintain unused lines of bank credit in excess of the notes issued at any one moment.

Commercial paper was first issued in the money market in Canada in 1954. It is a method of short-term borrowing used by certain major companies, often on a seasonal basis as a means of borrowing at a lower cost than through the chartered banks. The brief submitted by the Investment Dealers' Association to the Royal Commission on Banking and Finance showed the great savings that have been available at times to the companies issuing commercial paper to replace bank loans. It was these great savings that attracted an increasing number of companies into the market and the total of commercial paper outstanding grew quite rapidly to an estimated 231 million by 1961 and a peak of 384 million in early 1965, from which point it has declined considerably to 167 million at the end of 1965. The reasons for this decline will be considered later in this report.

The instrument by which the borrower raises funds in the commercial paper market is a simple promissory note. This means a promise to pay the individual or company named a certain amount of money at a certain place on a certain day. There is usually no prospectus and the only document available is often the legal opinion that the company has the power to borrow money by this method. In many cases the companies also agree to maintain unused lines of bank credit equal to or in excess of the short-term paper outstanding.

It is interesting to note the remarks in 1962 of D. H. Fullerton on this subject "The issuing of commercial paper tends to be more haphazard than that of finance paper. Few companies issue a prospectus defining the terms on which their paper is issued. . . . Corporate notes are occasionally issued in error without proper authority, and without investigation by the investment dealer or anyone else of the company's capacity to repay the notes. Some uniformity of approach is gradually evolving because of the strict requirements of some lenders, in particular the trust companies, and because of investment dealer experience. No company should issue paper, nor should a dealer sell it, without

presentation of documentary evidence that the appropriate borrowing by-law and board resolutions had been passed authorizing the issue of notes, and that the opinion of counsel had been obtained that the company is in good standing and the promissory note is a valid evidence of debt. . . . The dealer often forgets that as a seller of the paper he is morally if not in fact an endorser of the company's credit and the growing dealer practice of taking paper in inventory and using it for buy backs does commit him directly. He is certainly not paid for the risks he assumes, and benefits little from the commission he receives." These remarks, written three years ago, ring just as true today. Recently the Investment Dealers' Association has been working on some suggestions for I.D.A. members in order to produce uniform standards in the money market.

The main buyers of finance and commercial paper are probably the trust companies taken as a group; however, in the past five years the amount of funds received from non-resident sources has at times been very considerable.

Figures produced by the Dominion Bureau of Statistics and referring to finance company paper only show nonresident holdings in September, 1964 at 495 million of which 493 million was owned by residents of the United States. At this date total finance company paper outstanding was 1,162 million so that non-residents held approximately 42.6% of which nearly all was held by residents of the United States.

Recently United States participation in the Canadian money market has declined for two main reasons; (1) the "guidelines" which on a voluntary basis set out ways whereby U.S. corporations and financial institutions can help reduce the outflow of funds from the U.S.A.; (2) the unpleasant aftermath of the failure of Atlantic Acceptance Corporation. More detailed comments on both these points appear later in this report.

Other large scale buyers of commercial paper have been the financial institutions such as the life insurance companies as well as industrial and mining companies. In general the buyers of commercial paper are all potential buyers of finance company notes and choose between the two types of investment according to the different rates and credits available. However, not all the buyers of finance paper are prepared to buy commercial paper.

**Atlantic Acceptance Corporation Limited**

The company was founded in 1953 but does not appear to have issued its first short-term note in the money market until 1959. In May of that year the month-end figures showed that there were then $50,000 of short-term notes outstanding but by the end of the same year the amount outstanding was in excess of $2,100,000. The growing use that

the company made of the facilities available to it in the money market for the issuance of short-term notes with a maturity of under 365 days can be seen from the following year-end figures.

| | | |
|---|---|---|
| December 31, | 1960 | $ 8,600,000. |
| | 1961 | $10,300,000. |
| | 1962 | $21,800,000. |
| | 1963 | $27,600,000. |
| | 1964 | $41,200,000. |
| June 17 | 1965 | $55,200,000.[2] |

Month-end figures of short-term notes outstanding from May, 1959 to June, 1965 are shown in the tables at the end of this report (Table A). These figures include bank loans from U.S. banks but exclude loans in Canadian funds from the Canadian banks. It can, therefore, be seen that the company grew in six years to the point where it was using $55 million of money raised in the short-term market. The money market was providing Atlantic with one-third of the total funds it required and at a relatively low rate of interest.

The company was growing very quickly throughout this period, not only in business done but in the opening of new branches and the acquisition or creation of companies in related financial fields. Support for the company through the purchase of its common and preferred shares had come originally from Lambert & Co., a private investment firm in New York. Through Lambert & Co., the United States Steel and Carnegie Pension Fund became the first major institution to invest in Atlantic when they purchased subordinated debt and equity in 1959. Subsequently the Ford Foundation also became an investor with the purchase of subordinated notes and preferred and common shares as well as an eventual investment in the secured notes.

These two Funds decided to invest in the company after careful consideration and with the view that the possible increase in the value of the equity they purchased justified the risk involved in providing funds for the subordinated debt of a company of this size.

In the case of the United States Steel and Carnegie Pension Fund, this was a continuation of a policy that had proved to be very successful over a number of years.

Each year the earnings of Atlantic increased, judging by the audited figures provided by the accountants and this encouraged other institutions to follow the example of the original investors, although each institution made its own analysis and credit checks before committing long-term funds.

[2]This figure evidently includes redemption premiums and excludes the S.F.C.I. note in relation to which default occurred—S.H.S.H.

In the money market the short-term paper of the company was receiving better distribution and more powerful sponsorship year by year. By 1963, according to company records, all but one of the fifteen money market dealers in Canada appear to have been involved at one time or another in the placement of the short-term notes. In addition, various highly respected United States investment houses had begun to play a very important role in the distribution of the long-term debt as well as to a more limited extent, the short-term paper. Atlantic adopted a policy of paying short-term interest rates that averaged ⅛ to ¼ of 1% per annum higher than the rates being paid by Industrial Acceptance Corporation or Traders Finance Corporation for money offered on similar terms. This point was brought out in the evidence to the Commission of Mr. B. L. McFadden, ex-Treasurer of Atlantic Acceptance Corporation. In addition, Atlantic paid a commission calculated on the basis of 36 cents per year for every $100 borrowed. This is 3 cents per $100 per month, or put more simply, Atlantic would pay a dealer approximately $300.00 commission for placing a note for $1 million for one month or $3,600 if the note was for one year.

This commission rate compared with 24 cents per $100 per year paid by Industrial Acceptance Corporation and Traders Finance. General Motors Acceptance Corporation paid about the same commission as I.A.C. although the method of calculation is different.

Thus, Atlantic was paying rates for money in excess of those paid by the major companies and was also rewarding the dealer with 50% more commission.

These points were definitely a factor in facilitating the distribution of Atlantic short-term notes.

The fact that the long-term debt of the company was held by many of the largest institutions in the United States appears not to have been as great a selling point in the placement of the short-term paper as has been implied. A fact of this nature was naturally of great potential value in persuading any investor who hesitated, but in fact only a few of those responsible for the purchase of Atlantic notes for their corporations or institutions, when interviewed, gave the fact of the excellent list of long-term investors and equity holders as a reason for buying the paper. Several claimed to have been unaware of this fact until after the company defaulted on its debt and the stories appeared in the press.

The more usual comments were that the investment was made because Atlantic was on the list of short-term borrowers with whom the officer was permitted to place corporate or institutional funds. Or that the paper was secured by 115% of collateral with a major trust company as trustee, so there was no thought of a credit problem. That the investment dealer in Canada or New York had been relied on and only a cursory check made of the figures shown in the prospectus. Strangely, the dealers appear to have been relied on more heavily, and therefore

came in for more criticism among Canadian investors involved in Atlantic than among the United States institutions and corporations caught in the same situation, whereas the opposite reaction might have been expected with the United States investors working at a distance relying on a Canadian investment dealer, as Atlantic was and is a Canadian company. A summation of the remarks made by the U.S. institutions on the rôle of the dealers would be that the dealers' function was to show the account any attractive opportunity to invest and that it was then up to the account to do its own research and make up its own mind. On the other hand, the view of some short-term noteholders in Canada was that they had relied extremely heavily on the dealer involved and had looked to him to screen the paper he offered.

Some investors, but only a few, cited the higher interest rates offered by Atlantic as a reason for buying the short-term notes. This factor, however, appears to have been more important than was disclosed in interviews since the extra ⅛ or ¼ of 1% must have been a factor in more instances than were admitted. If rate was not an important factor, then one feels the corporate investor would have chosen one of the larger and longer established companies as a vehicle for a short-term investment. Some Canadian accounts spoke of their knowledge of the company through their bankers and the fact that they had a high opinion of the firm of auditors who signed the 1964 Annual Report. One or two accounts spoke of buying Atlantic short-term notes in order to diversify or because of the fact that the paper was secured by 115% of collateral as opposed to 112½% collateral provided by some other major Canadian finance companies.

During the course of discussions with the investors who were facing possible losses as a result of ownership of Atlantic securities, it became possible to detect a migration of responsibility away from the individuals involved in the actual transaction. A typical example would be a corporate treasurer with short-term funds to invest who made his first investment in Atlantic in, say, 1962 after careful consideration and a fairly detailed presentation of the company by the dealer concerned. At this point the corporate treasurer and his superiors, if they were involved, would be satisfied by the information on Atlantic. There would also be some reliance placed on the judgment of the investment dealer.

After a period of a year or so of fairly consistent investment of short-term funds with Atlantic there might perhaps be a change in corporate treasurer, but at any event through competitive forces other dealers would begin to do business with the corporation.

The new investment dealers in an effort to secure money market business would be offering various short-term notes and as the corporation had already purchased Atlantic Acceptance paper through another dealer, the new dealers would offer the notes of Atlantic without necessarily considering their offering of the paper as a recommendation of

the credit of Atlantic. The new dealers would merely regard this as an agency transaction in the paper of a company whose credit had already been accepted by the corporate investor. This type of a situation was more frequent than might be supposed as Atlantic tended to pay rates in excess of the other major companies and so was frequently offered in competitive situations. As can be seen by this example, a gap in the chain of responsibility can develop in situations such as this where a corporation has a list of companies with which it is prepared to place funds, then, through a change in personnel the original corporate officers who recommended and approved the names are not in day-to-day control of the investment of funds. The new officer feels only slight concern as he is investing in "approved" names and on the other side the dealers feel only small responsibility as they are acting as agents in a competitive situation where the account is likely to buy the highest-yielding paper available from his list of approved companies.

Table B shows the breakdown of the maturities of the short-term notes of Atlantic Acceptance outstanding at the end of each quarter and then monthly for the year 1964 and 1965. The figures show the increasing reliance on really short-term funds that was forced on Atlantic as money became more difficult to find. At the same time, the increasing importance of U.S. funds can be seen from Table A which reveals U.S. pay notes comprising up to 40% of total short-term notes outstanding.

In addition to the amount borrowed in U.S. dollars by way of short-term notes, there was also a further amount of paper expressed in Canadian dollars but held by non-residents, mostly residents of the United States.

Table C shows the total of sales finance and consumer loan companies and also commercial short-term notes outstanding issued by Canadian finance companies at dates by month or quarter ends from September 1961 to December 1965. These figures are from the August, 1966 Bank of Canada Statistical Summary. The totals are further broken down into those notes payable in Canadian funds and those payable in United States funds.

Table D shows the amount of short-term paper issued by Canadian finance companies and held by non-residents at certain quarter ends, segregated by ownership, regardless of currency of payment, into two categories, Non-residents and Residents of the United States.

From these tables it can be seen that Atlantic relied more heavily on non-resident funds than did the remainder of the Canadian finance companies. This reliance on non-resident sources of funds exposed Atlantic to dual risks:

(1) Insofar as the borrowing was in U.S. dollars, there was always the possibility of a change in the value of the Canadian dollar in relation to the U.S. dollar. This was an appreciable risk in that nearly

all Atlantic's assets in the way of loans or receivables made in the ordinary course of their business were expressed in Canadian dollars. Thus, a devaluation of the Canadian dollar, as in fact occurred in 1962, would have caused Atlantic a loss at the time notes due in U.S. funds became payable.

(2) There was a further risk that became more serious and eventually became the immediate cause of Atlantic's downfall and this was the risk that the U.S. lenders might become influenced in their investment decisions by regulations imposed by the U.S. Government. This is where the "guidelines" which were announced in February 1965 began to affect Atlantic as the U.S. investors withdrew short-term funds from Canada in response to the voluntary guidelines, and in an effort to improve the U.S. balance of payments. This matter is dealt with in greater detail later in this report.

A very important factor affecting Atlantic's financing plans over the final three years from 1962 to 1965 was the progressively more vigorous application of the guidelines brought out in the United States and designed to improve the balance of payments position of that country. The guidelines were an outgrowth of the Interest Equalization Tax first announced in June of 1962 which added a tax of 15%, or approximately 1% per annum to the cost to a non-resident of raising money in New York, by way of either equity or more particularly debt financing, Canada was given a specific exemption covering new issues of securities and this exemption has continued. However, other factors including moral suasion directed at the U.S. lenders and aimed at overseas lending but not including loans made in Canada, began to have an effect on the funds available to Canadian finance companies in both the money market and also the long-term market. This effect came about from a view that although Canada was exempted it was still perhaps unpatriotic to worsen the U.S. Balance of Payments by any short-term investment out of the U.S.A.

On February 10, 1965 this position was altered by the announcement of new guidelines, designed to reduce overseas capital investment by U.S. corporations. Once again it was a voluntary program and Canada was excluded but the following paragraph referring to short-term funds was included in the letter of the Secretary of Commerce sent out to about 600 U.S. corporations:

> "We do not anticipate cutbacks in Canadian investments, but firms should take particular care to assure that short-term funds put at the disposal of your subsidiaries in Canada serve only to meet operating needs in Canada. Opportunities should be explored for obtaining at least a portion of working capital requirements from the Canadian market. In this process, we hope that short-term investments in Canada by parents or subsidiaries clearly in excess of working requirements

will not be increased. No doubt opportunities will arise to reduce these balances, particularly those denominated in U.S. dollars, but this should be done only in a gradual and orderly way."

At the end of January 1965 Atlantic had short-term notes outstanding of $51,000,000 excluding Canadian bank loans. Of this figure, $21,300,000 appear to have been held by U.S. residents and $8,435,-000 by subsidiaries of U.S. companies. At the time of default on June 14, 1965 the total was $51,250,000 excluding Canadian bank loans and of this $18,100,000 was held by U.S. corporations and $13,000,000 by the subsidiaries of U.S. companies, as well as $3,000,000 U.S. by an American bank. Thus, the U.S. guidelines had begun to have some effect on the note holdings and were definitely having an effect on the indications as to renewal at maturity of the large amount of money represented by notes due June 14 and in the next few days. It was the fact that the American holders of notes maturing in June were showing an inclination to withdraw their funds that was making it inevitable that Atlantic would have increasing difficulty in finding funds in the future. Their apparent position with U.S. holders would have been worse but for the fact that some of the notes due in June had been purchased prior to the February 10 guidelines and also by paying higher rates than other finance companies as well as higher dealer commissions, they were able to attract a larger proportion than usual of the funds held in Canada by U.S. corporations or subsidiaries of U.S. corporations.

One of the major problems that Atlantic faced as a result of the company's heavy reliance on funds from the United States was that as it continued to expand and, therefore, required additional new funds it had to find not only the amount of new funds required but additional funds to replace the funds from the United States which were withdrawn when notes became due. In addition, funds from the United States tended to be of a 90-day or longer maturity and were therefore particularly welcome to a company which was growing as fast as Atlantic. It should also be pointed out that in 1965 Atlantic's bank lines were only as follows:

| | |
|---|---|
| Toronto-Dominion Bank | $3,700,000 |
| Royal Bank | 2,000,000 |
| Bank of Nova Scotia | 750,000[3] |
| | $6,450,000 |

In fact, the Toronto-Dominion Bank was in the habit of allowing the bank loan to go higher than $3,700,000 and in early June, the bank arranged to purchase a $4,000,000 note in U.S. funds through its International Department. In May the First National City Bank also came

[3]Line of credit was to Commodore Sales Acceptance Limited.

to the assistance of the company with $3,000,000 U.S. in the form of a four-month note. These were a special form of bank accommodation and were immediately utilized, leaving very little in the way of standby credit. This was becoming particularly important to Atlantic now that they were having to scour the money market for chiefly Canadian funds which were characterized by their very short term.

It is perhaps worth commenting on the significance and reason for so many of Atlantic's short-term notes that were held in the United States falling due on or about June 15. In the United States it is customary for corporations to pay income taxes four times a year. The quarterly payment dates are March 15, June 15, September 15 and December 15. Many large corporations are therefore in the position of knowing that major sums in cash have to be available to meet taxation liabilities on those dates. Because these are known dates, commitments can be made anything up to six months ahead. These are therefore convenient dates for the corporations to cover by their short-term investments in Canada, where they probably receive an overall improvement in yield of, say, ½ of 1%.

The foreign exchange experts at the banks know of the importance of these dates and of the large volume of funds in transit on these occasions. Therefore, they are able to quote highly competitive rates for forward foreign exchange contracts to mature on these tax dates. This adds up to an additional inducement to take advantage of the higher overall interest rates often available to a U.S. investor to invest in Canada to these dates.

This, then, is one of the important reasons why Atlantic had so many notes falling due around June 15. These tax dates were also particularly dangerous since, for the very reason that the corporations had invested the funds to that particular date in order to pay their tax commitments, the funds were not likely to be available for immediate reinvestment with Atlantic.

If the end had not come in June, 1965, Atlantic was building up a similar problem for the next tax date, September 15.

These tax dates are watched very closely by the major Canadian finance companies with a view to avoiding having a concentration of maturities at these particular dates. From evidence at the hearing, Atlantic officials were well aware of the danger but despite their efforts, were unable to avoid the situation developing since for the final four months before the company collapsed they had to accept whatever funds were offered regardless of any desire to avoid having large maturities on particular dates.

In addition to the problem of having maturities in June, Atlantic had been accepting a considerable amount of funds on demand. Some of this money was on 24-hour recall, which meant the lender could call the note and be repaid without penalty and with accrued interest one

day after giving verbal notice of intent to call the note. Other notes were on demand with the privilege granted to the lender to get his money back the same day as intent to call was advised to Atlantic. These were very volatile funds and Atlantic felt obliged to take them as they represented funds from within Canada and therefore relatively less susceptible to 'guidelines' from the U.S. Government. Some of these demand funds were from Canadian subsidiaries of U.S. parents and so might be directly affected by the guidelines but the main amount of the demand funds were from Canadian institutions and corporations.[4]

In some instances it was Atlantic's readiness to take funds on the terms and conditions of the lender that enabled Atlantic paper to be sold to accounts who initially would only accept it on a demand or very short-term basis, but who subsequently continued to purchase notes on a more permanent basis.

It is strange in retrospect to find a company which at January 31, 1965, for example, had a bank line of credit of only $3,700,000, all of which was being used, but which had demand notes outstanding for $5,825,000 that were subject to call on either one day's notice or no notice at all. If a fact such as this had been discovered, it is reasonable to suppose that few lenders would have been interested in the short-term notes of Atlantic since there was nowhere for the company to turn should its demand notes be called or some of its term notes prove difficult to renew or replace at maturity.

It is interesting to note in a speech delivered on June 22, 1965 by Dr. Andrew F. Brimmer, Assistant Secretary of Commerce for Economic Affairs the statement that U.S. corporations had cut back their holdings of short-term Canadian financial assets by the end of March 1965 to the level of December 1963. Figures provided in tables issued at the time of Dr. Brimmer's speech showed that "foreign short-term financial assets held by firms participating in the voluntary program with the Department of Commerce" were $670 million held in Canada directly and through banks at the end of 1963 and $753 million held by "foreign Affiliates of Reporting Firms". These figures at December 31, 1964 were 1,029 million and 741 million respectively so that to return to the end of 1963 figures the decline would have had to be 350 million in total.

Figures for finance company notes held by U.S. residents as shown by the Dominion Bureau of Statistics increased during the same period by 162 million, which means the decline must have come from deposits withdrawn from the chartered banks or the sale of other short-term investments, such as Government of Canada bonds or commercial paper not covered in the Dominion Bureau of Statistics report. Bank of Canada figures confirm that chartered bank deposits in U.S. dollars from U.S.

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[4]For amounts of demand notes outstanding see Table B, p. 1558.

residents declined by 530 million between December 31, 1964 and June 30, 1965.

These figures point to the fact that the guidelines were only partially effective as far as the finance companies were concerned and that the finance companies were still able to obtain funds by paying more than other borrowers. The main decline in non-resident deposits in Canadian institutions was definitely falling on the Canadian banks up to the time of the failure of Atlantic in June 1965. In the months after June 1965 the whole position changed dramatically. This aspect will be considered in a later portion of this report.

### The Money Market After the Collapse of Atlantic Acceptance Corporation

At the time of the announcement of Atlantic Acceptance's default on its short-term notes on June 15, 1965, the total amount of short-term finance company paper outstanding in Canada totalled approximately $1,160 million, which was close to the all-time month-end record of $1,173 million set in July, 1964 (see Table C). The July, 1964 figure, however, includes some paper of Delta Acceptance, which was merged with Avco Corporation in May, 1965 and subsequent to that date the Bank of Canada figures were altered to exclude Delta paper on the grounds that the company's short-term borrowings had been reorganized. The figure of $1,160 million is arrived at by taking the figure shown in the August, 1966 edition of the Bank of Canada statistics as being the amount of short-term finance paper outstanding at the end of June, 1965 and to this figure adding the amount of Atlantic Acceptance short-term paper outstanding excluding loans from Canadian banks, but including loans from foreign banks. The end of June figure is probably more accurate than the end of May, since the market effect of Atlantic's failure probably does not show in the figures until later.

Of this figure of $1,160 million some $433 million was owned by non-residents of which $409 million was U.S. owned. From the figures provided by the Dominion Bureau of Statistics (see Table D) it can be seen that the United States holdings of Canadian short-term finance paper had been declining ever since the end of September, 1964 and had fallen by $75 million by June, 1965. Thus, although the guidelines had apparently not had as much effect on Atlantic's short-term paper total as might have been expected, the guidelines had certainly started to affect the overall totals of the industry with regard to the amount of United States funds invested in Canadian short-term finance paper.

To explain what occurred in the money market it is necessary to reconstruct the feeling in the market place at the time of Atlantic's default on its outstanding securities. Up to the moment of the announcement of the trouble with Atlantic there had been no thought of any problem, although there had from time to time been predictions that there

would be a moment when some issuers of short-term paper would get into trouble. In general, the smaller commercial paper issuers were the ones under suspicion, on the grounds that the borrowing techniques used in conjunction with commercial paper were less carefully organized than with the finance companies. As mentioned earlier, very few issuers of commercial paper produce a prospectus and the notes are not secured in any way except by the general credit of the corporation. Furthermore, there is no trustee. It was therefore towards this area of the market that those who predicted trouble were looking. Finance company paper with its $115.00 or so of collateral of receivables pledged behind each $100.00 appeared less likely to get into difficulties. Atlantic with its known backers was a company that, although it had perhaps grown too fast and had relied on United States lenders to too great an extent, was not likely to be in serious difficulty. It was generally known in the money market that Atlantic required funds and would pay higher rates than most for almost any money of whatever term was available, but this was thought to be a temporary problem, caused by the effect of the 'guidelines' on United States lending and likely to be resolved once the June 15 tax date had been safely passed.

This, then, was the background on the day of default. Ninety-day finance company rates were 4¾%, having moved up from 4½% about three weeks previously and in general money was getting harder to find.

Initial reaction in the market was a stunned disbelief. The most usual explanation was "temporary lack of funds caused by the impact of the guidelines on lenders from the United States". In addition, there was at the time the belief that at the very least all the short-term notes which were the senior secured notes of the company as well as the long-term senior secured notes would be paid plus all accrued interest as soon as the necessary refinancing could be accomplished. This belief was encouraged by the statements published June 16 and attributed to Mr. C. P. Morgan, President of Atlantic Acceptance Corporation, to the effect that the company would have no difficulty in eventually meeting all its obligations and that noteholders would be paid in full. The holders of the short-term notes of other finance companies, particularly the smaller ones, became concerned and were anxiously waiting to get their money back but as most finance company notes are written for fixed terms and are not cashable on demand, the immediate decline in total notes outstanding was far less than might have been expected.

The end of July total of finance company short-term notes outstanding was down some $49 million but in August the total increased surprisingly by $25 million, possibly due to a special non-resident, but non United States, purchase of finance company notes. This purchase appears to have represented a special situation which was not a normal factor in the market. After August the decline in total notes outstanding really became noticeable. By the end of September all the ninety-day

notes placed in June had matured and in addition a heavy September 15 maturity of notes held by United States companies were in large measure not renewed. It should be emphasized that September 15 was the next major United States corporate tax payment date after June 15. U.S. participation in Canadian sales finance paper declined by $80 million or 20% between the end of June and the end of September (see Table D). By the end of December, 1965, the total was down by a further 19% to $268 million or 61% of the end of June figure.

During this period bank loans by the Canadian chartered banks to the sales finance companies had been rising rapidly from $280 million at June 16 to $527 million at December 31, 1965—an increase of $247 million during a period when short-term notes of the finance companies had declined in excess of $200 million (see Table E).

The report of the Governor of the Bank of Canada in the Bank's 1965 Annual Report deals with the failure of Atlantic Acceptance as follows:

> "CREDIT AND LIQUIDITY STANDARDS. The failure of Atlantic Acceptance in June had a disturbing impact on financial institutions and markets which was compounded by rumours regarding a trust company which had large investments in Atlantic and which was taken over by another trust company in September. There was some risk that soundly-managed institutions which had exercised prudence in the conduct of their business might find themselves in a position of difficulty and be unable to renew maturing short-term obligations until the confidence of investors had been restored. The dangers arising out of this situation were major concern to the central bank.
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> Immediately after the default, the Bank of Canada added to the cash reserves of the chartered banks in order to ease the liquidity of the banking system and financial markets generally. Within a few days I consulted with the chartered banks and indicated to them that while I did not wish to influence their judgement as to the credit standing of any customer I hoped that they would not feel unable, for reasons relating to the total amount of their resources, to accommodate credit-worthy finance companies which might find themselves in a difficult liquidity position. This unusual step was taken because in the atmosphere prevailing at the time there was a risk that difficulties in any part of the credit system might have wider repercussions of a disturbing character. For their part, the chartered banks recognized that it was in the general interest that serious liquidity difficulties be avoided and their action in making additional credits available was helpful in the circumstances.
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> While the central bank is not entrusted with the function of appraising the soundness of the participants in the credit market, it is nevertheless very concerned with the maintenance of confidence in all parts of the financial system. Where such confidence is in danger of being seriously impaired the central bank may have to allow itself to be diverted from the pursuit of the current objectives of monetary policy and give priority

> to measures which help to maintain confidence. The events of last summer provided a dramatic illustration of the extent to which the whole financial system is dependent on the maintenance of high credit and liquidity standards, on the disclosures of adequate information, on the exercise of discrimination by investors and lenders, and on satisfactory arrangements for supervision and inspection of all parts of the credit system."

The Governor's remarks as quoted above provide a concise comment on the effect of Atlantic's failure on the market place. The prompt action of the Governor in meeting with the chartered banks and encouraging, as well as facilitating, the increased lines of credit that the finance companies required had an important effect on the sentiment in the money market.

The bare figures of finance company paper outstanding by no means indicate all that had been going on in the money market during the final six months of 1965. Investors were making a basic reappraisal of their methods of short-term investment. Senior management were setting out new instructions for the investment of short-term funds by treasurers. There was a move to raise the standards by which corporations judge a credit to be acceptable for inclusion in corporate portfolios. Only the larger finance companies or those with guarantees from U.S. parents were able to sell any appreciable amounts of notes.

During the latter half of 1965 the paper outstanding of the Canadian subsidiaries of U.S. finance companies increased from a total of $441 million at end of June to $463 million at end of December, while comparable figures for the Canadian-owned finance companies were $661 million at end of June and $439 million at the end of December, 1965. Thus, there had been a dramatic switch by the buyers away from the Canadian-owned finance companies to those finance companies that were guaranteed by large U.S. parents (see Table F).

Earlier comments about the relatively minor effect of the February 10, 1965 guidelines on U.S. holdings of short-term finance company paper up to the time of Atlantic's default no longer hold true after the default, as U.S. funds were rapidly withdrawn from the sales finance companies and as mentioned in the previous paragraph, the withdrawal from the Canadian-owned finance companies was even more noticeable as clearly funds were switched from Canadian-owned to U.S.-owned finance companies in a natural reaction by both U.S. and Canadian investors. In addition, U.S. residents withdrew some $157 million from sales finance paper in Canada. There is little doubt that a considerable portion of this $157 million was repatriated immediately to the United States but part may also have been placed on deposit with the Canadian chartered banks who during this period were paying excellent rates for deposits. Although deposits of U.S. residents in U.S. funds with the chartered banks increased from $1,051 million at the end of June, 1965

to $1,225 million at the end of August before declining to $1,059 million at the end of December, the banks were however attracting substantial quantities of resident and non-resident deposits in Canadian funds. The banks were using the funds available from the higher deposit rates to meet the much increased demand for loans—partly from the finance companies who, unable to sell their short-term notes in the money market, were increasingly forced to rely on their bank lines of credit. There was thus the situation developing where the lenders of funds were withdrawing from direct financing of the sales finance companies and were instead placing their surplus short-term funds on deposit with the chartered banks who, in their turn, were in part utilizing these funds to make additional loans to the finance companies to replace the funds withdrawn by the original lenders.

The finance companies themselves were moving to curtail their need for new funds and drastically reducing their plans for expansion. One of the finance companies[5] sold a total of $13 million of receivables to other finance companies and omitted dividends on the common and second preferred shares in order to conserve funds during this difficult period. Other major finance companies went to the long-term market to borrow funds and also raised additional equity by rights issues. The United States long-term lenders who had been such major investors in Atlantic were naturally reluctant to commit new funds to other finance companies in Canada and demanded additional information from would-be borrowers. However, to their credit they did continue, and are continuing to, lend money after careful scrutiny, to some finance companies in Canada.

The Federated Council of Sales Finance Companies has been instrumental in drawing up a series of recommendations for the finance companies to use in reporting figures. These new moves are the result of a survey completed by the Federated Council in the three months after the Atlantic default. The recommendations in general indicate that Canadian finance companies are moving closer to the reporting procedures customary in the United States. The major Canadian-owned finance companies have issued detailed supplements which set out in very great detail a mass of information that has never been publicly released before. This type of disclosure will set a high standard for the industry.

The recommendations of the Federated Council of Sales Finance Companies are here produced in full:

> "The Board of Directors has concluded that the situation prevailing in Atlantic Acceptance and the specific events that caused the default, far from being characteristic of this industry, represent an exception which runs contrary to the experience of the Canadian sales finance

[5]Union Acceptance Corporation.

industry and the sound operating structure that has been built over four decades. It is clear that this industry is ultimately as sound as the jobs, paycheques and personal integrity of the hundreds of thousands of individual Canadians who have purchased their cars and other durable goods on instalment contracts which the sales finance companies have purchased from dealers. In order to assure investors in short-term notes and other interested parties such as investment dealers and the chartered banks of the continued sound practices of the industry, the Board of Directors makes the following recommendations to the members of the Federated Council:

1. That the members provide detailed and standardized statistical and financial information to investors and dealers similar to that available regarding sales finance companies in the United States. This may be accomplished by adapting for Canadian use such forms as:

    (a) The Robert Morris Associates sales finance company questionnaire, and

    (b) The so-called 'long form audit' of operations.

    This will provide the facts required for the development of information and ratios contained in the various U.S. bank reports on instalment sales finance companies.

    It is our conclusion that the adoption of these standards of statistical information, their continued use, and their widespread dissemination, will enable investors in the debt and equity instruments of this industry to form an appropriate and complete picture of the nature and trend of the business of each particular member company, and the soundness of its business practices. Individual members should endeavour to explain to investment dealers and purchasers of short-term notes the value of such information, since part of the recent difficulties were due to the lack of understanding on the part of dealers and investors themselves.

2. That the members of the Federated Council selling short-term notes to investors, either directly or through investment dealers, should provide a high degree of liquidity in connection with short-term note issues as a safeguard against those relatively rare times when the smooth flow of short-term funds is temporarily interrupted. To this end the members of the Federated Council selling short term notes should at all times have substantial alternatives to their short-term note issues consisting of cash, highly liquid investments and unused and available bank credit lines."

The important aspects of these recommendations are the use of the "Robert Morris Associates Sales Finance Company Questionnaire" and the use of the "Long Form Audit" of operations as well as the comment about increased liquidity. This standardization of reporting procedures, if and when achieved, will enable investors to compare the credits of the various companies in the market.

The chartered accountants have held meetings to decide on certain problems that occur in auditing finance companies where standardization appears desirable. One of the main points under consideration is the taking in of unearned income in the year the contract is purchased, or specifically what is a reasonable proportion of the total earnings on a contract to include in the current year's operation as a cost of acquiring the business.

One important weakness of the money market in short-term finance companies notes has been the relatively small lines of credit when compared with short-term notes outstanding that the finance companies each had with their bankers (see Table G). There is an historical reason for this which goes back to early 1956 when bank lines of credit to the sales finance companies were arbitrarily cut by the banks.[6] This experience led the finance companies to question the value of lines of credit that were not firm. An attempt was made by some of the banks in co-operation with the finance companies to set up "paid for" lines of credit. These were to be lines of credit paid for by the finance company when not being used but in return for the payments received there would be an inference that the lines of credit would always be considered firm. It was this point that led to disagreement between the banks and as unanimity among the banks was not reached the idea of substantial paid for lines of credit lapsed since unless all the large banks participated the idea became impractical as the total line available to any one company would not be sufficient.

In the United States it is customary for a finance company issuing short-term paper to have firm lines of credit with the banks equal to the amount of notes due within one year. These lines of credit are paid for by the method of compensating balances and a finance company may have lines of credit with several hundred banks throughout the United States.

The method of compensating balances requires the company which has a line of credit to keep a certain percentage of that line of credit on deposit earning no interest. This can amount to 20% of the line of credit but in return for this, the line of credit is considered firm and available at all times although subject to negotiation from time to time. Lines of credit are usually negotiated on an annual basis. Some U.S. investors requested information on the bank lines of credit of the Canadian finance companies but because of the factors outlined above eventually accepted a situation where the unused lines of credit of the finance companies represented only a small percentage of notes due within one year. In the case of Atlantic Acceptance there were very few occasions

[6]Subsequently in May, 1959 the banks cut each finance company line of credit to the peak amount used in 1958 and then in August lines of credit were further curtailed to the amount then in use.

during 1964 or 1965 when unused bank lines of credit amounted to even 10% of short-term notes outstanding. Table G shows bank lines of credit for the sales finance companies and their overall liquidity which can be seen to vary between 41% and 67%. It was, therefore, explained to the investor that lines of credit on the scale customary in the U.S. were just not available from Canadian banks for the reasons outlined above.

From the point of view of the Canadian banks it is only fair to comment that their experience was that the finance companies only used the lines of credit when money became too expensive elsewhere, which was just when the banks least wanted to make large loans to the finance companies.

The method used by many Canadian finance companies to raise short and long-term funds by the use of secured notes issued under a trust deed has been called into question by the failure of Atlantic Acceptance and also by the so-called "Ross Action".[7]

It is clear that the major lending institutions in the United States would prefer to see a finance company use the unsecured method of borrowing, which is the method most commonly used by finance companies in the United States.

If a finance company is to borrow by issuing unsecured notes, it covenants to preserve a certain ratio of equity and junior unsecured notes to senior unsecured notes. This ratio is usually expressed as follows: The Company may borrow $8.00 by way of senior unsecured debt provided there is $1.00 of equity and $1.00 of junior unsecured debt.

The finance company itself retains control of all the receivables in its various offices across the country. These receivables are subject to annual outside audit and to internal audit controls but the paramount factor is clearly the quality of management. In order for borrowing to be handled by this method, it is essential that the short-term notes outstanding be supported by 100% or very close to 100% of liquidity. This would involve initially an increase in long-term borrowing, an increase in bank lines of credit, if available, and the formation of a portfolio of liquid short-term investments.

One of the important side issues involved in a move to unsecured borrowing would be the fact that the chartered banks, who at present normally request collateral for finance company loans, would be asked in future to make loans on an unsecured basis, since clearly no long-term lender is going to be happy to lend money on an unsecured basis

[7]This action brought against the Montreal Trust Company as trustee has been discontinued but the position of the plaintiff, Donald Ross, has been substantially assumed by the Connecticut General Life Insurance Company in its own action now pending. (See Chapter IV, p. 103)—S.H.S.H.

to a finance company whose bank loans are on a secured basis. If the banks agree to lend on an unsecured basis, it would mean that they would become the most important check on the credit of the finance companies. The chartered banks are not anxious to put themselves in this position, although it is considered a normal procedure in the United States. The finance companies have also represented that as the banks are their competitors they are not anxious to see them in a position to rule on the credit of the industrial finance companies. On the other hand, the chartered banks are the only institutions equipped to do this job and to whom the job is vitally important in order to protect their own interests as lenders. Furthermore, the chartered banks are in a position to charge for their trouble through a system of paid for lines of credit.

The Federated Council of Sales Finance Companies has suggested that the Investment Dealers Association might perform the task of credit rating the industry; however, this does not seem practical as the I.D.A. itself is not equipped to perform this service and furthermore, its members normally act as agents rather than as principals in placing finance company paper. Investment dealers should certainly take a far more responsible attitude towards the credit of the companies whose short-term notes they distribute and it should be regarded as no real consolation that many major lenders place no blame on the dealers involved in the Atlantic débâcle. However, it seems only logical that the main responsibility for rating credit should rest with those who have something tangible to lose if their judgment or procedures are faulty.

In an effort to improve their liquidity position one of the leading Canadian finance companies set out to obtain substantial lines of credit from banks in the United States.[8] This initiative proved to be successful and the exposure of the company's affairs to the U.S. lending institutions has been of great value to the company during the period following the failure of Atlantic. There were at the end of 1965 U.S. lines of credit outstanding to Canadian finance companies of perhaps $60 million with only perhaps $20 million of these lines in use as at December 31, 1965.

The finance companies were the most obvious sufferers, other than Atlantic security holders, as a result of the failure of Atlantic Acceptance but they were not the only ones. In fact, the whole money market went through an agonizing period which is still continuing. During this period there was a massive reappraisal of credit and investors in the money market became suddenly far more conscious of quality rather than of rate in planning their money market investments. There were many examples of corporate investors refusing to purchase any finance company paper of any kind, whether guaranteed by a United States parent or not. In these instances short-term funds were invested in

[8]Laurentide Financial Corporation Limited.

Government of Canada treasury bills or short-term bonds or placed on deposit with the Canadian chartered banks or even withdrawn from Canada.

During the period from June-December, 1965, interest rates rose sharply in all sectors of the money market, including the rates on Government of Canada securities. The treasury bill rate rose from 3.98% on June 10 to 4.54% by December 29, while the yield on one-year Government bonds increased from 4.22% to 5.08%. On the other hand, finance company notes for three-month money increased from 4¾% to 6% during the same time. From the chart (Table H) attached it can be seen that the spread in rates between finance company rates and the treasury bill rate widened noticeably in contrast to the move to the higher interest rates which occurred in 1962. In 1962 it was the Canadian dollar that was under suspicion and high interest rates were necessary on all short-term instruments in order to attract foreign money. In 1965, it was the finance companies whose credit was suddenly suspect and hence the spread in yields developed between the rates on Government securities and finance company notes.

For reasons explained in the Bank of Canada Annual Report, the Bank of Canada increased the banking system's cash reserves for a period after the failure of Atlantic Acceptance to "guard against the possibility that other financial institutions might come under serious liquidity pressure". (See page 26 of Bank of Canada 1965 Report.)

This action by the Bank of Canada had a stabilizing effect, particularly on treasury bills where the average at the weekly tender remained between 3.93 and 4.08 throughout the second half of June and all through July and August. The rate on treasury bills still remained very constant throughout September, October and November, but started to climb rapidly in the month of December after the Bank Rate was raised from 4½% to 4¾% on December 6 and to 5¼% on March 14, 1966.

The failure of Atlantic Acceptance was in part responsible for the increase in yields throughout the money market but there was also a general move to tighter credit conditions as the economy continued to expand. From the Annual Report of the Bank of Canada, it can be seen that the special moves that were made by the Bank of Canada in concert with the banking system to help restore confidence in the money market possibly postponed somewhat the incidence of the still tighter credit conditions that might have been appropriate were it not for the necessity of dealing with the aftermath of Atlantic.

Another very important factor was the effect of the "guidelines" issued by the United States Government in early February. These were designed to help the U.S. balance of payments by encouraging the repatriation to the United States of funds held in Canada in the form of short-term notes or bank deposits. As mentioned earlier, the effect of this guideline was being felt in Canada within one month.

Commercial paper outstanding which amounted to about $361 million at the end of May 1965 declined rapidly to $167 million at the end of December 1965. However, part of this decline was accounted for by a switch in the method of borrowing from commercial paper to Bankers' Acceptances. This switch came about as the result of a reduction in the fee charged by the banks for "accepting" eligible paper. This reduction was from approximately 1½% per annum to ½ of 1% and resulted in Bankers' Acceptances outstanding climbing from 9 million at the end of May 1965 to 150 million at the end of December 1965. Accounts that borrowed by means of Bankers' Acceptances did so mainly because they were unable to borrow the funds they required through the issuance of commercial paper and so resorted to Bankers' Acceptance which at the time of the reduction in the acceptance fee had become not only cheaper than issuing commercial paper but also easier to place in the money market.

The other main change that resulted from the failure of Atlantic was the marked move away from all forms of investment in the paper of the finance companies or in commercial paper and the transfer of such funds to deposits with the chartered banks.

Table K is reprinted from the Bank of Canada Annual Report for 1965, page 30, and shows quite dramatically the change that took place during 1965 in the resident holdings of the various categories shown.

In particular, the figures show increase in resident holdings of chartered bank term deposits from $1,494 million at December 1964 to $2,303 million at December 1965, an increase of $809 million. Resident holdings of finance company paper dropped by $50 million from $600 million to $550 million.

**Conclusion**

The presence of an active money market in Canada was essential to the fast growth of Atlantic Acceptance from a small company in 1959 to a $155 million complex in 1965. However, the money market should not be saddled with the major share of the blame for the sad circumstances that developed. Fault can be found with the dealers in one area, and that is that they tended to pursue the commissions available on finance company paper with perhaps too great a singleness of mind. One reason for this was the decline in the volume of trading and the profit to be derived from the market for Government of Canada bonds. The recently more stable interest rate patterns in Canada contrast markedly with those in force in the late 1950's and the opportunity for profitable trading in these securities has diminished with the result that more dealers have turned their attention to the placement of finance

company paper, thus making this area more competitive and hence easier for companies such as Atlantic to expand their operations.

It is true to say that the dealers involved should have delved deeper into the company's affairs and if such research had been done in a really detailed manner, then it seems probable that the true situation would have been discovered. However, the large institutional investors each at one time or another carried out some kind of research before purchasing the long-term debt of the company and they found very little about which to be disturbed. It is ironic that Atlantic was considered notable among Canadian finance companies borrowing in the United States in that the company was prepared to give out more detailed figures than almost any other finance company. There is now some question as to the value of these figures but at the time they were accepted as being correct in that they were certified by management and audited by a firm of chartered accountants.

The segment of the money market most seriously hurt by the failure of Atlantic was and is the placement of finance company short-term notes. The figures quoted earlier and the tables published at the end of this report show how the amount of notes outstanding fell quite sharply and the interest rate rose by 1¼% in the latter half of 1965. The finance companies received support in the form of additional loans beyond their lines of credit with the chartered banks. The statement of the Governor of the Bank of Canada in the 1965 Annual Report reveals the rôle played by the central bank at this point when confidence had been shaken and a period of reappraisal and slow recovery was needed.

At this point the finance companies, who are using bank loans because of their inability to raise money in the short-term market, are not being hurt to any great extent by the fact of using bank funds rather than market funds as either source is about equally expensive, but their problem is that they dare not expand their operations until they are assured once again of market support.

One of the most unfortunate aspects of the failure of Atlantic Acceptance is that it has made it more difficult for the Canadian-owned finance companies to raise funds in the market than the American-owned companies. The figures in Table F attached to this report illustrates this quite clearly with the increase in notes issued by American-owned finance companies in the six months ending December 31, 1965 to be set against the decline in short-term notes issued by the Canadian-owned finance companies.

It may become difficult for the Canadian-owned finance companies to compete for business with the U.S.-owned finance companies in Canada in what is a very competitive market, if the main source of borrowed funds available to these companies is the long-term market,

where money on an average costs 1% more than money raised by selling short-term notes. There is also a considerable loss of flexibility if long-term funds are used, since a time may come when the demand for the services of the finance companies declines and therefore the companies have a reduced requirement for funds.

The finance companies in Canada require greatly increased liquidity as was very clearly illustrated by the hectic search for short-term funds carried out by Atlantic Acceptance just prior to its failure. The same point was again well illustrated by the remaining finance companies as their notes outstanding were reduced under the impact of the crisis in confidence brought on by Atlantic's failure.

By liquidity is meant the ability of the finance company to handle with ease note maturities in the event money to replace or renew the notes is not forthcoming. Liquidity is usually measured in percentages and is described as 100% when all note maturities due within one year are covered by firm unused lines of bank credit or by short-term investments held in reserve.

In Canada a striving for increased liquidity is now in progress with the finance companies stepping up their efforts to attract long-term funds and thus cut down their reliance on the short-term market. In addition increased lines of bank credit are being sought, both here and in the United States. Lines of credit from U.S. banks have been granted recently to serve major Canadian finance companies after the U.S. banks had been provided with additional figures under conditions of fuller disclosure by the finance companies. These lines of credit are firm but as the major part of the business of the finance companies in Canada is in Canadian currency these lines of credit in U.S. dollars are not quite as useful as the lines from the Canadian banks. The risk of a change in the exchange rate between United States and Canadian currency is a risk that has to be taken by the borrower. The risk can be diminished over any short fixed period by the purchase of a foreign exchange forward contract, but where the term of the loan from a United States bank is indefinite, which is usually the case, then it is impossible to eliminate completely all risk of a change in the value of the Canadian dollar vis-à-vis the United States dollar.

The relationship between the finance companies and the banks is one that is subject to strain since they are in direct competition with each other throughout the country in the consumer finance field. However, the finance companies are also important loan customers of the banks and it is to be hoped that the problems associated with the failure of Atlantic Acceptance and their gradual solution will lead to a better relationship developing where both industries acknowledge the need for co-operation at least on the commercial banking side of their day by day operations.

The most often repeated comment by the large institutional investors was one that has little direct bearing on the subject of this report, but grows out of the criticism by the institutions of the lack of information available to investors about Canadian corporations. The U.S. institutions were the first to admit that they had not been forced to invest in Canada, but had been attracted by the security and the higher rates available. Some investments had been made to satisfy various Government regulations concerning the deposit of securities by those insurance companies carrying on business in Canada, but in the main the purchase of Canadian securities was the result of an investment decision. They were thus in a position to refuse to invest when adequate information was not available; however, under competitive pressure and with large amounts of money to place their standards had relaxed somewhat and they had made investments in companies which, unlike Atlantic, provided little detailed information.

The major institutional lenders in the U.S.A. almost unanimously commented on the lack of an "S.E.C." in Canada. Much as many of them had disagreed with the concept of the Securities and Exchange Commission when it was originally set up in 1933, they were now prepared to admit that it had played an extremely important rôle in the improvement in the climate for investment in the U.S.A. In some cases these investors were not aware of the fact that in Canada securities legislation is a provincial responsibility but even so they stressed that an improvement in this area, or even a uniformity in provincial acts and a great deal tougher legislation in general, particularly with regard to disclosure, would benefit the country by making it easier for non-resident institutions to invest with confidence. In theory this should also lead to funds being made available to Canadian companies at interest rates closer to those prevailing in the United States, although this would be dependent on many other factors.

This factor of confidence in Canadian securities legislation and enforcement is perhaps more than usually important at this time. As a country we are dependent on capital infusions from abroad and yet we wish to retain as much control over our major companies as possible. It is therefore preferable to receive the foreign capital we require by way of the sale of long-term debt securities. However, if the foreign investors do not have confidence in our system of securities legislation or in our securities markets, they are likely to prefer to invest only where they can obtain effective control, which is usually through substantial purchases of equity.

Under the Interest Equalization Tax Act in the United States a U.S. company is exempt from the payment of the 15% tax if it purchases or owns in excess of 10% of the outstanding equity of a Canadian company. Therefore, the Interest Equalization Tax is, in itself, no deterrent when the acquisition of control is being considered.

The money market in Canada is showing considerable resilience as it recovers from the aftermath of the Atlantic failure. In years it is a very young market that "has had a remarkably trouble-free development and has evolved into a smooth mechanism transferring short-term funds from lenders to borrowers" (Royal Commission on Banking and Finance, page 321). Now the market has been faced by its first serious internal credit problem as opposed to the crisis in 1962 over the devaluation of the dollar. A problem of this nature will provide a lesson and add a new depth of experience for those who operate in this market. It is hoped that the lessons of this sad affair will not be quickly forgotten, regardless of the final decision of the Royal Commission as to where the blame really lies.

**An Explanation of "Bank Rate"**

In Canada, the "bank rate" is set by the Bank of Canada, the central bank, and remains fixed until changed. The rate, which is currently 5¼% is the rate at which the chartered banks may obtain advances against collateral of Government of Canada securities deposited with the Bank of Canada.

Each chartered bank has a line of credit with the Bank of Canada and may obtain an advance up to this amount from the Bank of Canada upon request. However, if a chartered bank makes use of this facility, it must continue the loan for a full week. The chartered bank may only use this line of credit once a month although should the chartered bank require the advance for a second period of one week then this will be granted although the interest rate charged by the Bank of Canada for this second week is subject to negotiation and is normally set at a higher rate than "bank rate".

Loans at "bank rate" are also available from the Bank of Canada to the money market dealers who have been granted lines of credit at the Bank of Canada. These loans are made by purchase and re-sale agreements of Government of Canada short-term securities. The dealers have the additional option to receive their advances from the Bank of Canada at the "discount rate" should this be below "bank rate".

The "discount rate" is set each week at ¼ of 1% below the average rate at which the three month Government of Canada Treasury Bills sell at auction.

TABLE A

ATLANTIC ACCEPTANCE CORPORATION SHORT-TERM NOTES OUTSTANDING (NEAREST $1,000) ex CANADIAN BANK LOANS BUT INCLUDING LOANS FROM U.S. BANKS

| *End of Month* | | *Canadian Pay* | *U.S. Pay* | *Total* |
|---|---|---|---|---|
| May | 1959 | 50,000 | — | 50,000 |
| June | " | 402,000 | — | 402,000 |
| July | " | 919,000 | — | 919,000 |
| August | " | 869,000 | — | 869,000 |
| September | " | 968,000 | — | 968,000 |
| October | " | 1,218,000 | — | 1,218,000 |
| November | " | 1,667,000 | — | 1,667,000 |
| December | " | 2,117,000 | — | 2,117,000 |
| January | 1960 | 2,670,000 | — | 2,670,000 |
| February | " | 2,270,000 | — | 2,270,000 |
| March | " | 3,395,000 | — | 3,395,000 |
| April | " | 4,262,000 | — | 4,262,000 |
| May | " | 5,262,000 | — | 5,262,000 |
| June | " | 5,187,000 | — | 5,187,000 |
| July | " | 5,237,000 | — | 5,237,000 |
| August | " | 6,541,000 | 35,000 | 6,576,000 |
| September | " | 8,241,000 | 35,000 | 8,276,000 |
| October | " | 7,394,000 | 35,000 | 7,429,000 |
| November | " | 9,607,000 | 35,000 | 9,642,000 |
| December | " | 8,587,000 | 35,000 | 8,622,000 |
| January | 1961 | 7,758,000 | 35,000 | 7,793,000 |
| February | " | 7,743,000 | — | 7,743,000 |
| March | " | 6,994,000 | — | 6,994,000 |
| April | " | 7,243,000 | 35,000 | 7,278,000 |
| May | " | 7,580,000 | 35,000 | 7,615,000 |
| June | " | 7,203,000 | 35,000 | 7,238,000 |
| July | " | 11,410,000 | — | 11,410,000 |
| August | " | 11,990,000 | — | 11,990,000 |
| September | " | 11,401,000 | 20,000 | 11,421,000 |
| November | " | 11,910,000 | 10,000 | 11,920,000 |
| December | " | 10,321,000 | 10,000 | 10,331,000 |
| January | 1962 | 14,380,000 | 10,000 | 14,390,000 |
| February | " | 14,437,000 | 10,000 | 14,447,000 |
| March | " | 18,041,000 | 10,000 | 18,051,000 |
| April | " | 19,868,000 | 10,000 | 19,878,000 |
| May | " | 21,244,000 | 10,000 | 21,254,000 |
| June | " | 17,150,000 | 510,000 | 17,660,000 |
| July | " | 19,264,000 | 2,510,000 | 21,774,000 |
| August | " | 18,920,000 | 3,500,000 | 22,420,000 |
| September | " | 17,680,000 | 3,510,000 | 21,190,000 |
| October | " | 12,717,000 | 3,510,000 | 16,227,000 |
| November | " | 14,316,000 | 4,505,000 | 18,821,000 |
| December | " | 11,400,000 | 10,450,000 | 21,850,000 |

| *End of Month* | | *Canadian Pay* | *U.S. Pay* | *Total* |
|---|---|---|---|---|
| January | 1963 | 13,423,000 | 10,250,000 | 23,673,000 |
| February | " | 11,513,000 | 7,155,000 | 18,668,000 |
| March | " | 14,125,000 | 6,615,000 | 20,740,000 |
| April | " | 14,160,000 | 6,465,000 | 20,625,000 |
| May | " | 14,173,000 | 7,115,000 | 21,288,000 |
| June | " | 14,459,000 | 5,924,000 | 20,383,000 |
| July | " | 17,665,000 | 5,260,000 | 22,925,000 |
| August | " | 18,526,000 | 7,717,000 | 26,243,000 |
| September | " | 20,703,000 | 6,075,000 | 26,778,000 |
| October | " | 20,841,000 | 6,131,000 | 26,972,000 |
| November | " | 25,725,000 | 6,920,000 | 32,645,000 |
| December | " | 22,544,000 | 5,033,000 | 27,577,000 |
| January | 1964 | 24,242,000 | 9,273,000 | 33,515,000 |
| February | " | 25,708,000 | 9,763,000 | 35,471,000 |
| March | " | 25,203,000 | 9,914,000 | 35,117,000 |
| April | " | 29,895,000 | 10,714,000 | 40,609,000 |
| May | " | 34,717,000 | 11,056,000 | 45,773,000 |
| June | " | 32,408,000 | 10,941,000 | 43,349,000 |
| July | " | 41,023,000 | 9,916,000 | 50,939,000 |
| August | " | 35,530,000 | 13,153,000 | 48,683,000 |
| September | " | 30,694,000 | 13,300,000 | 43,994,000 |
| October | " | 19,167,000 | 18,621,000 | 37,788,000 |
| November | " | 26,113,000 | 17,505,000 | 43,618,000 |
| December | " | 26,428,000 | 14,792,000 | 41,220,000 |
| January | 1965 | 29,512,000 | 21,482,000 | 50,994,000 |
| February | " | 33,438,000 | 19,403,000 | 52,841,000 |
| March | " | 37,413,000 | 11,484,000 | 48,897,000 |
| April | " | 40,851,000 | 11,303,000 | 52,154,000 |
| May | " | 36,371,000 | 16,453,000 | 52,824,000 |
| June | " | 31,270,000 | 19,953,000 | 51,223,000 |

TABLE B

## ATLANTIC ACCEPTANCE CORPORATION

## SHORT-TERM NOTES OUTSTANDING AT MONTH ENDS INCLUDING BANK LOANS

| | | *Total* | *On Demand* | *Due Within 14 Days* | *Due Within 14-30 Days* |
|---|---|---|---|---|---|
| December | 1963 | 28,800,000 | 1,250,000 | 3,024,000.00 | 3,408,000.00 |
| March | 1964 | 38,300,000 | 5,515,000 | 5,733,273.00 | 4,781,000.00 |
| June | 1964 | 49,100,000 | 8,797,000 | 7,172,000.00 | 7,662,000.00 |
| September | 1964 | 45,200,000 | 2,040,000 | 8,521,556.35 | 11,095,000.00 |
| December | 1964 | 48,000,000 | 11,000,000 | 484,500.00 | 1,250,000.00 |
| January | 1965 | 54,000,000 | 5,825,000 | 8,829,000.00 | 4,100,000.00 |
| February | 1965 | 53,100,000 | 6,883,000 | 6,569,757.48 | 10,093,035.96 |
| March | 1965 | 55,100,000 | 12,775,000 | 11,530,082.00 | 9,008,000.00 |
| April | 1965 | 54,100,000 | 12,235,000 | 11,311,552,31 | 5,110,000.00 |
| May | 1965 | 57,574,015 | 10,000,000 | 11,139,875.88 | 13,885,000.00 |
| June 14 | 1965 | 58,413,135.77 | 8,550,000 | 19,287,400.00 | 4,393,009.65 |

AUGUST 1966

TABLE C

# SHORT-TERM PAPER OUTSTANDING[1]

| | *Sales Finance and Consumer Loan Companies*[2]* | | | *Other Commercial Borrowers*[3] | | | *Total** | | |
|---|---|---|---|---|---|---|---|---|---|
| | *Canadian Dollars* | *Foreign Currency* | *Total* | *Canadian Dollars* | *Foreign Currency* | *Total* | *Canadian Dollars* | *Foreign Currency* | *Total* |
| | | | *Millions of Canadian Dollars* | | | | | | |
| 1961—Mar. | 565 | 37 | 602 | 235 | 3 | 238 | 800 | 40 | 840 |
| June | 564 | 35 | 599 | 192 | 2 | 194 | 756 | 37 | 793 |
| Sept. | 489 | 28 | 517 | 266 | 5 | 270 | 755 | 33 | 787 |
| Dec. | 465 | 26 | 491 | 227 | 4 | 231 | 692 | 30 | 722 |
| 1962—Mar. | 512 | 26 | 538 | 282 | 5 | 287 | 794 | 31 | 825 |
| June | 540 | 39 | 578 | 208 | 18 | 226 | 748 | 57 | 805 |
| Sept. | 570 | 38 | 608 | 226 | 38 | 264 | 796 | 76 | 872 |
| Dec. | 580 | 54 | 634 | 267 | 22 | 290 | 847 | 76 | 924 |
| 1963—Mar. | 706 | 48 | 754 | 307 | 16 | 323 | 1,013 | 64 | 1,077 |
| June | 725 | 64 | 789 | 307 | 10 | 316 | 1,032 | 74 | 1,105 |
| Sept. | 706 | 70 | 776 | 335 | 16 | 351 | 1,041 | 86 | 1,127 |
| Dec. | 733 | 68 | 801 | 227 | 15 | 241 | 960 | 83 | 1,042 |
| 1964—Jan. | 852 | 82 | 934 | 323 | 15 | 338 | 1,175 | 97 | 1,272 |
| Feb. | 868 | 93 | 961 | 330 | 9 | 340 | 1,198 | 102 | 1,301 |
| Mar. | 884 | 102 | 986 | 305 | 13 | 318 | 1,189 | 115 | 1,304 |
| Apr. | 932 | 114 | 1,046 | 299 | 10 | 309 | 1,231 | 124 | 1,355 |
| May | 1,006 | 122 | 1,128 | 299 | 13 | 312 | 1,305 | 135 | 1,440 |
| June | 1,039 | 124 | 1,163 | 265 | 11 | 276 | 1,304 | 135 | 1,439 |
| July | 1,021 | 152 | 1,173 | 274 | 14 | 287 | 1,295 | 166 | 1,460 |
| Aug. | 917 | 160 | 1,077 | 277 | 12 | 289 | 1,194 | 172 | 1,366 |
| Sept. | 900 | 187 | 1,087 | 290 | 13 | 303 | 1,190 | 200 | 1,390 |
| Oct. | 887 | 185 | 1,072 | 296 | 12 | 308 | 1,183 | 197 | 1,380 |
| Nov. | 876 | 186 | 1,062 | 323 | 14 | 337 | 1,199 | 200 | 1,399 |
| Dec. | 858 | 202 | 1,060 | 274 | 14 | 287 | 1,132 | 216 | 1,347 |
| 1965—Jan. | 881 | 242 | 1,123 | 323 | 14 | 336 | 1,204 | 256 | 1,459 |
| Feb. | 914 | 231 | 1,145 | 369 | 14 | 384 | 1,283 | 245 | 1,529 |
| Mar. | 965 | 184 | 1,149 | 339 | 15 | 354 | 1,304 | 199 | 1,503 |
| Mar.[2] | 903 | 140 | 1,044 | | | | 1,242 | 155 | 1,398 |
| Apr. | 924 | 148 | 1,072 | 297 | 17 | 313 | 1,220 | 165 | 1,385 |
| May | 918 | 162 | 1,080 | 342 | 20 | 361 | 1,259 | 182 | 1,441 |
| June | 917 | 168 | 1,085 | 301 | 15 | 316 | 1,218 | 183 | 1,401 |
| July | 866 | 170 | 1,036 | 232 | 37 | 269 | 1,098 | 208 | 1,305 |
| Aug. | 869 | 192 | 1,061 | 241 | 36 | 278 | 1,110 | 228 | 1,339 |
| Sept. | 775 | 160 | 935 | 233 | 28 | 261 | 1,008 | 188 | 1,196 |
| Oct. | 686 | 188 | 874 | 202 | 22 | 223 | 887 | 210 | 1,097 |
| Nov. | 739 | 176 | 916 | 228 | 17 | 245 | 968 | 190 | 1,157 |
| Dec. | 700 | 142 | 842 | 153 | 13 | 166 | 853 | 155 | 1,008 |
| 1966—Jan. | 820 | 179 | 998 | 202 | 17 | 218 | 1,021 | 195 | 1,217 |
| Feb. | 854 | 173 | 1,027 | 251 | 13 | 264 | 1,105 | 186 | 1,291 |
| Mar. | 843 | 142 | 985 | 260 | 16 | 276 | 1,103 | 158 | 1,261 |
| Apr. | 905 | 112 | 1,017 | 250 | 12 | 262 | 1,155 | 124 | 1,279 |
| May | 934 | 98 | 1,032 | 237 | 12 | 249 | 1,171 | 110 | 1,281 |
| June | 901 | 107 | 1,008 | 211 | 18 | 229 | 1,112 | 125 | 1,237 |

SOURCES: Dominion Bureau of Statistics, Bank of Canada.

* Revised from December 1963 in accordance with revisions made by D.B.S. in *Business Financial Statistics* and the exclusion of short-term loans from foreign banks.

1. Notes with an original term of one year or less. Does not include short-term borrowing from foreign banks, notes placed with Canadian chartered banks or with parent companies. Bankers' acceptances are not included.
2. Includes finance company subsidiaries of automobile manufacturers. Quarterly statistics up to March 1965 are as published by the Dominion Bureau of Statistics in *Business Financial Statistics* and intervening months are estimated on the basis of monthly reports received by the Bank of Canada. There is a break in the series following March 1965 owing to the exclusion of part of the paper of one company and all of the paper for another. In the first case the borrowings of the company were reorganized in May after it merged with a U.S. company, and in the second case the company went into receivership and its paper into default in June. In order to give a consistent series the paper affected by these developments has been excluded in the second set of March figures and in the following months. The difference between the two March figures is accounted for by these adjustments and by some differences in coverage.
3. Includes finance company subsidiaries of merchandisers and of manufacturers other than automobile companies. The statistics up to June 1963 are from a survey by the Royal Commission on Banking and Finance published on page 257 of the Commission's Appendix Volume. The series have been brought up to date by the Bank of Canada on the basis of reports from companies known to have issued a very high proportion of total short-term paper outstanding.

TABLE D

HOLDINGS BY NON-RESIDENTS OF SHORT-TERM CANADIAN FINANCE COMPANY PAPER

(Millions of Dollars)

| | *All Non-Residents* | *Residents of the United States* |
|---|---|---|
| 31 December 1962 | 189 | 187 |
| 31 March 1963 | 209 | 208 |
| 30 June 1963 | 211 | 210 |
| 30 September 1963 | 233 | 232 |
| 31 December 1963 | 282 | 280 |
| 31 March 1964 | 389 | 387 |
| 30 June 1964 | 491 | 490 |
| 30 September 1964 | 495 | 493 |
| 31 December 1964 | 478 | 476 |
| 31 March 1965 | 444 | 440 |
| 30 June 1965 | 442 | 418 |
| 30 September 1965 | 381 | 338 |
| 31 December 1965 | 316 | 268 |
| 31 March 1966 | 332 | 286 |
| 30 June 1966 | 326 | 267 |

Prepared in the Dominion Bureau of Statistics, Balance of Payments Section
Revised 27 September, 1966

TABLE E

CHARTERED BANK AUTHORIZED CREDITS AND LOANS OUTSTANDING TO ALL SALES FINANCE COMPANIES

(Millions of Dollars)

| *Month-End* | *Authorized Credits of $100,000 or more*[1] | *Total Loans Outstanding*[2] |
|---|---|---|
| 1960 — December | 622.3 | 371.0 |
| 1961 — January | | 320.5 |
| February | | 321.3 |
| March | 606.9 | 295.6 |
| April | | 315.0 |
| May | | 304.9 |
| June | 500.4 | 295.6 |
| July | | 285.4 |
| August | | 266.4 |
| September | 517.3 | 248.0 |
| October | | 243.0 |
| November | | 235.8 |
| December | 534.7 | 272.9 |
| 1962 — January | | 249.5 |
| February | | 236.2 |
| March | 563.1 | 257.0 |
| April | | 266.9 |
| May | | 252.1 |
| June | 606.5 | 325.7 |

TABLE E (Continued)

| Month-End | Authorized Credits of $100,000 or more[1] | Total Loans Outstanding[2] |
|---|---|---|
| July | | 290.0 |
| August | | 276.3 |
| September | 567.4 | 268.0 |
| October | | 269.7 |
| November | | 258.4 |
| December | 580.8 | 283.7 |
| 1963 — January | | 250.8 |
| February | | 251.8 |
| March | 570.5 | 260.5 |
| April | | 259.8 |
| May | | 257.7 |
| June | 604.0 | 247.9 |
| July | | 277.9 |
| August | | 232.2 |
| September | 622.1 | 254.0 |
| October | | 242.0 |
| November | | 253.6 |
| December | 624.7 | 302.0 |
| 1964 — January | | 251.1 |
| February | | 258.6 |
| March | 634.3 | 278.9 |
| April | | 269.8 |
| May | | 258.3 |
| June | 664.7 | 294.7 |
| July | | 277.2 |
| August | | 300.0 |
| September | 661.1 | 243.1 |
| October | | 277.6 |
| November | | 270.6 |
| December | 685.6 | 298.8 |
| 1965 — January | | 264.8 |
| February | | 274.8 |
| March | 695.1 | 287.8 |
| April | | 294.9 |
| May | | 280.3 |
| June | 672.1 | 356.8 |
| July | | 384.5 |
| August | | 386.0 |
| September | 710.7 | 425.0 |
| October | | 442.1 |
| November | | 440.6 |
| December | 754.3 | 526.8 |

[1]Data have not been published.
[2]Includes a small amount of loans outstanding under authorizations of less than $100,000.
Source: Bank of Canada.

TABLE E(1)

CHARTERED BANK AUTHORIZED CREDITS AND LOANS TO SALES FINANCE COMPANIES

(Millions of Dollars)

| | | *To 20 Sales Finance Cos.*[1] | | *To All Companies* |
|---|---|---|---|---|
| *1965* | | *Total Authorized Credits* | *Total Loans Outstanding* | *Total Loans Outstanding* |
| June | 9 | 228.8 | 75.5 | 255.4 |
| | 16 | 228.9 | 104.2 | 279.7 |
| | 23 | 230.5 | 128.0 | 298.2 |
| | 30 | 231.4 | 164.6 | 356.8 |
| July | 7 | 233.6 | 168.0 | 352.5 |
| | 14 | 247.6 | 158.8 | 351.5 |
| | 21 | 249.0 | 171.5 | 376.9 |
| | 28 | 266.6 | 158.6 | 368.7 |
| | (31) | | | (384.5) |
| Aug. | 4 | 272.4 | 181.6 | 414.0 |
| | 11 | 281.8 | 185.1 | 401.0 |
| | 18 | 281.8 | 180.9 | 373.7 |
| | 25 | 288.4 | 175.9 | 364.2 |
| | (31) | | | (386.0) |
| Sept. | 1 | 287.9 | 174.9 | 366.2 |
| | 8 | 288.5 | 184.4 | 366.4 |
| | 15 | 286.3 | 184.4 | 384.1 |
| | 22 | 285.6 | 197.7 | 375.7 |
| | 29 | 284.1 | 209.4 | 391.0 |
| | (30) | | | (425.0) |
| Oct. | 6 | 287.2 | 203.3 | 389.0 |
| | 13 | 296.0 | 203.8 | 397.3 |
| | 20 | 296.1 | 197.7 | 391.6 |
| | 27 | 298.2 | 203.2 | 415.2 |
| | (31) | | | (442.1) |
| Nov. | 3 | 297.0 | 226.0 | 427.6 |
| | 10 | 296.9 | 217.5 | 417.9 |
| | 17 | 297.1 | 226.2 | 420.3 |
| | 24 | 298.7 | 198.7 | 394.9 |
| | (30) | | | (440.6) |
| Dec. | 1 | 298.5 | 215.9 | 442.8 |
| | 8 | 296.2 | 226.7 | 442.8 |
| | 15 | 298.3 | 254.6 | 487.5 |
| | 22 | 298.7 | 239.2 | 480.1 |
| | 29 | 302.8 | 249.9 | 497.1 |
| | (31) | | | (526.8) |

[1]This group does not include any subsidiaries of U.S. companies. *Data have not been published.*

Source: Bank of Canada.

TABLE F

ESTIMATED SALES FINANCE COMPANY SHORT-TERM PAPER OUTSTANDING
(Month-end—$ millions)

| | *Issued by subsidiaries of U.S. companies* | | *Issued by all other companies* | | *Total* | | |
|---|---|---|---|---|---|---|---|
| | *Canadian Dollars* | *Foreign Currency* | *Canadian Dollars* | *Foreign Currency* | *Canadian Dollars* | *Foreign Currency* | *Total* |
| *1963* | | | | | | | |
| Dec. | 253 | 10 | 461 | 57 | 714 | 67 | 781 |
| *1964* | | | | | | | |
| Jan. | 293 | 12 | 540 | 69 | 833 | 80 | 913 |
| Feb. | 318 | 13 | 532 | 78 | 850 | 91 | 941 |
| Mar. | 336 | 15 | 529 | 84 | 870 | 99 | 969 |
| Apr. | 372 | 15 | 542 | 95 | 915 | 110 | 1,024 |
| May | 388 | 18 | 596 | 98 | 984 | 116 | 1,101 |
| June | 387 | 29 | 630 | 89 | 1,017 | 118 | 1,135 |
| July | 390 | 27 | 611 | 119 | 1,001 | 146 | 1,147 |
| Aug. | 343 | 29 | 561 | 126 | 904 | 155 | 1,059 |
| Sept. | 361 | 48 | 533 | 133 | 894 | 181 | 1,075 |
| Oct. | 335 | 48 | 544 | 131 | 879 | 180 | 1,058 |
| Nov. | 321 | 53 | 545 | 128 | 866 | 181 | 1,047 |
| Dec. | 327 | 48 | 517 | 154 | 844 | 202 | 1,047 |
| *1965* | | | | | | | |
| Jan. | 340 | 59 | 525 | 181 | 865 | 240 | 1,105 |
| Feb. | 351 | 54 | 543 | 174 | 894 | 228 | 1,122 |
| Mar. | 386 | 34 | 554 | 145 | 940 | 180 | 1,120 |
| Mar.[1] | 386 | 8 | 518 | 133 | 903 | 140 | 1,044 |
| Apr. | 406 | 9 | 518 | 139 | 924 | 148 | 1,072 |
| May | 401 | 6 | 517 | 156 | 918 | 162 | 1,080 |
| June | 439 | 6 | 476 | 162 | 915 | 169 | 1,084 |
| July | 441 | 6 | 425 | 161 | 866 | 167 | 1,033 |
| Aug. | 479 | 8 | 390 | 181 | 869 | 189 | 1,058 |
| Sept. | 434 | 6 | 340 | 155 | 774 | 161 | 935 |
| Oct. | 381 | 12 | 305 | 174 | 686 | 185 | 871 |
| Nov. | 440 | 12 | 299 | 161 | 739 | 173 | 913 |
| Dec. | 413 | 15 | 283 | 131 | 696 | 146 | 842 |
| 1966 | | | | | | | |
| Jan. | 519 | 16 | 301 | 160 | 820 | 176 | 995 |
| Feb. | 555 | 14 | 299 | 155 | 854 | 169 | 1,023 |
| Mar. | 544 | 20 | 296 | 125 | 840 | 145 | 985 |
| Apr. | 561 | 15 | 344 | 99 | 905 | 109 | 1,014 |
| May | 585 | 14 | 349 | 84 | 934 | 98 | 1,032 |
| June | 588 | 20 | 313 | 87 | 901 | 107 | 1,008 |

[1]There is a break in the series following March 1965 owing to the exclusion of part of the paper of one company and all of the paper of another. In the first case the borrowings of the company were reorganized in May after it merged with a U.S. company, and in the second case the company went into receivership and its paper into default in June. In order to give a consistent series the paper affected by these developments has been excluded in the second set of March figures and in the following months. The difference between the two March figures is accounted for by these adjustments.

TABLE G

SALES FINANCE COMPANIES

(Millions of Dollars)

| | (1) Canadian Bank Lines of Credit | (2) Canadian Bank Loans | (3) Unused Lines of Credit | (4) Other Liquid Assets | (5) S/T Notes Out-standing | (6) Liquidity % |
|---|---|---|---|---|---|---|
| 1962 March | 563 | 257 | 206 | N/A | 538 | N/A |
| June | 606 | 326 | 280 | N/A | 578 | N/A |
| September | 567 | 268 | 299 | 111 | 608 | 67% |
| December | 581 | 284 | 297 | 117 | 670 | 62% |
| 1963 March | 570 | 261 | 309 | 122 | 772 | 59% |
| June | 604 | 248 | 356 | 122 | 816 | 58% |
| September | 622 | 254 | 368 | 133 | 799 | 63% |
| December | 625 | 302 | 323 | 119 | 857 | 52% |
| 1964 March | 634 | 279 | 355 | 135 | 1047 | 46% |
| June | 665 | 295 | 370 | 145 | 1223 | 42% |
| September | 661 | 243 | 418 | 143 | 1162 | 48% |
| December | 686 | 299 | 387 | 142 | 1150 | 46% |
| 1965 March | 695 | 288 | 407 | 171 | 1242 | 47% |
| June | 672 | 357 | 315 | 160 | 1103 | 43% |
| September | 711 | 425 | 286 | 127 | 999 | 41% |
| December | 754 | 527 | 227 | N/A | 902 | — |

SOURCES: Columns (1) and (2)—Bank of Canada
Column (4) is total of certain items in Dominion Bureau of Statistics Quarterly 61-006, Table 3, page 8. Items totalled have been taken to be the liquid assets of the Sales Finance Companies
Column (5) From Bank of Canada Statistical Summary, February 1966

TABLE H

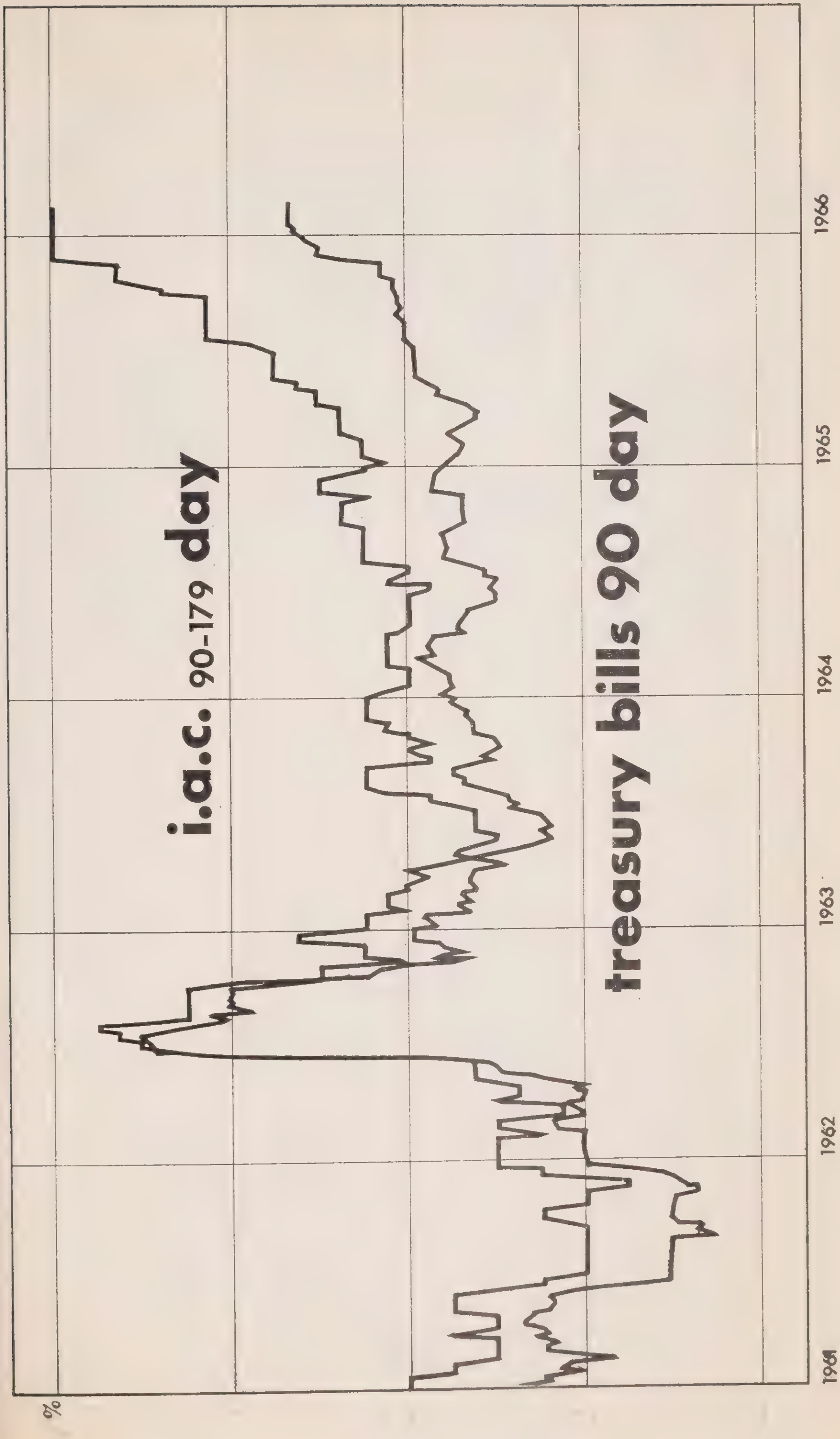
i.a.c. 90-179 day
treasury bills 90 day
1961
1962
1963
1964
1965
1966
%

Table I

ATLANTIC ACCEPTANCE CORPORATION
SHORT-TERM SECURED NOTES OUTSTANDING JUNE 17/65
TO NEAREST $100,000
TOTAL: $58,500,000

Breakdown

| | |
|---|---|
| U. S. Pay | $20,000,000 |
| Canadian Pay | $38,500,000 |
| Resident | $37,400,000 |
| Non Resident | $21,100,000 |
| Canadian Subsidiaries of U.S. Parents | $13,000,000 |
| Bank | |
| (U.S.) | $ 7,000,000 |
| (Canadian) | $ 3,250,000 |
| Associated Companies | $ 2,600,000 |
| British Mortgage | $ 2,400,000 |

TABLE J

THE INVESTMENT DEALERS
QUARTERLY ESTIMATES OF SELECTED MONEY MARKET
BALANCE SHEET ITEMS

| | 1962 | | 1963 | | | | 1964 | | | | 1965 | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 3Q | 4Q | 1Q | 2Q | 3Q | 4Q | 1Q | 2Q | 3Q | 4Q | 4Q | 2Q | 3Q |
| | Millions of Dollars | | | | | | | | | | | | |
| Selected assets | | | | | | | | | | | | | |
| 1. Cash on hand and on deposit: | | | | | | | | | | | | | |
| (a) In Canadian dollars: | | | | | | | | | | | | | |
| (i) Cash and bank deposits | 20 | 19 | 15 | 15 | 17 | 12 | 10 | 16 | 21 | 23 | 28 | 49 | 68 |
| (ii) Cash in other institutions<br>(b) In foreign currency | 5 | 6 | 12 | 9 | 10 | 8 | 7 | 7 | 2 | 55 | 35 | 2 | 14 |
| 2. Securities owned or managed at book value:[1] | | | | | | | | | | | | | |
| (a) Investments in Canadian securities: | | | | | | | | | | | | | |
| (i) Short-term notes of finance companies, commercial paper and bankers' acceptances | 21 | 22 | 32 | 45 | 46 | 66 | 84 | 105 | 150 | 162 | 146 | 136 | 132 |
| (ii) Government of Canada treasury bills | 96 | 159 | 94 | 165 | 163 | 187 | 105 | 115 | 116 | 126 | 78 | 117 | 75 |
| (iii) Other Government of Canada debt: | | | | | | | | | | | | | |
| (a) Term less than 3 years | 142 | 202 | 175 | 93 | 102 | 149 | 99 | 120 | 160 | 60 | 84 | 78 | 82 |
| (b) Term over 3 years | 50 | 54 | 28 | 45 | 23 | 12 | 15 | 33 | 24 | 40 | 63 | 5 | 67 |
| 3. Total securities outstanding under buy-back agreements | 70 | 50 | 91 | 131 | 110 | 112 | 114 | 188 | 107 | 201 | 189 | 236 | 178 |

[1]Net or short positions and excluding securities outstanding under buy-back agreements.
Source: Dominion Bureau of Statistics.

TABLE K

GENERAL PUBLIC HOLDINGS[1] OF CERTAIN FINANCIAL CLAIMS

(Millions of Dollars)

| | Dec. 1963 | Dec. 1964 | Dec. 1965 | Percentage Change 1964 | Percentage Change 1965 |
|---|---|---|---|---|---|
| Currency and chartered bank demand deposits | 6,296 | 6,693 | 7,130 | 6.3 | 6.5 |
| Chartered bank personal savings deposits | 8,357 | 8,846 | 9,642 | 5.9 | 9.0 |
| Quebec Savings Bank deposits | 347 | 376 | 402 | 8.4 | 6.9 |
| Trust and mortgage loan company demand deposits and certificates | 1,079 | 1,370 | 1,475 | 27.0 | 7.7 |
| SUB-TOTAL | 16,079 | 17,285 | 18,649 | 7.5 | 7.9 |
| Chartered Banks | | | | | |
| —non-personal term and notice deposits | 1,215 | 1,494 | 2,303 | | |
| —foreign currency deposits of residents | | | | | |
| —swapped | 408 | 718 | 549 | | |
| —other | 390 | 606 | 669 | | |
| Finance company short-term paper held by residents | 525 | 600 | 550 | | |
| Other commercial paper | 241 | 287 | 167 | | |
| Provincial and municipal short-term paper[2] | 230 | 160 | 250 | | |
| Bankers' acceptances | 9 | 11 | 150 | | |
| Government of Canada | | | | | |
| —treasury bills | 430 | 332 | 157 | | |
| —market bonds of maturity under 3 years | 1,776 | 1,402 | 1,441 | | |
| —Canada Savings Bonds | 5,133 | 5,613 | 5,866 | | |
| —Provincial Savings and Parity Bonds | 470 | 575 | 650 | | |
| —Trust company investment certificates | 1,279 | 1,478 | 1,930 | | |
| —Mortgage loan company debentures | 845 | 980 | 1,060 | | |
| TOTAL | 29,030 | 31,541 | 34,391 | 8.6 | 9.0 |

[1]This table includes relatively small amounts of some items held by non-residents.

[2]Estimated outstanding amount of short-term paper issued by provinces, municipalities and their enterprises.

# CHAPTER XX

## *Summary and Recommendations*

The first four chapters of my report deal with the event and results of the default of Atlantic Acceptance Corporation which occurred on June 14, 1965 and the establishment in consequence of the Royal Commission to inquire into its causes and effects, an account by way of introduction of the company's beginnings and early years from 1953 to 1959, a review of the corporate structure and development of the Atlantic companies and their financial position at June 17, 1965—the date of the order made by the Supreme Court of Ontario appointing the Montreal Trust Company receiver and manager of Atlantic Acceptance—the growth of these companies as revealed by their published financial statements, and finally an estimate of the immediate financial loss suffered by those who invested in Atlantic securities. Default occurred when a cheque drawn by Atlantic Acceptance on the Toronto-Dominion Bank for $5,000,000 plus interest from June 11 to June 14 in favour of Royal Securities Corporation Limited, acting as agent of S.F.C.I. Limited, a Montreal affiliate of French banking interests, was dishonoured when presented on the latter date. As evidence of its debt to S.F.C.I. Atlantic Acceptance had issued a short-term note, one of a series secured under the terms of a trust deed between the company and the Montreal Trust Company as trustee, charging the assets of Atlantic Acceptance as security for loans made to it by noteholders.

These assets, as in the case of all operating sales finance companies, consisted largely of notes and accounts receivable which, at the date of the receiving order made three days after default on the payment of the loan from S.F.C.I., amounted to $149,188,827 out of total assets of $154,809,926. Offsetting them, Atlantic Acceptance had at the same date liabilities of $137,177,278, of which upwards of $134,000,000 was owed to investors who had purchased its notes. These

notes, in descending orders of priority, were divided into categories described as senior, subordinated and junior subordinated, and were, except as to those issued prior to the execution of deeds of trust, secured by nineteen of these instruments for the benefit of the holders made between Atlantic Acceptance and the Montreal Trust Company as trustee in every case. The senior debt, secured by an assignment of notes receivable with a face value of 115% of the amount borrowed and a first floating charge on all the assets of the company, was divided into short-term, medium-term, and long-term notes, "short-term" being generally used to describe those due for payment in a year or less, "medium-term" within three years, and "long-term" after more than three years, and it was significant that, of the upwards of $105,000,000 worth of senior secured notes (excluding $5,010,000 plus accrued interest on which default had occurred), some $55,000,000 represented short-term borrowing. The subordinated debt amounted to approximately $16,666,000 and accrued interest, and the junior subordinated debt to $4,255,500. As a result of default on June 14, 1965 in respect of payment of notes in the amount of $5,010,000, of which S.F.C.I. held $5,000,000, the notes in all categories of debt became, according to the provisions of the trust deeds, due and payable forthwith.

**The Liquidity Problem**

From analysis of the terms and conditions of these notes, it is apparent that Atlantic, during the last year of its ostensibly solvent life, relied more and more on its ability to borrow short-term funds, predominantly in the United States, and upon the willingness of the lenders of these funds to "roll over" the indebtedness or, in other words, to renew the loan on similar terms when it became due. The economic "guidelines" established by President Johnson in the early months of 1965 virtually put an end to this, since American lenders responded to his suggestion that emphasis be placed upon domestic lending in order to correct imbalance in the international payments of the United States. Thus Atlantic, which had regularly paid fractionally more interest to lenders and a higher commission to dealers, and had acquired a reputation for always being ready to take any short-term money offered, was deprived at a critical moment of its last ready source of funds. This, however, was only the proximate cause of its collapse, since it had been consistently "borrowing short and lending long", or financing its loans against fixed term notes and conditional sales contracts, and wholesale and industrial loans against assignments of inventory and accounts receivable, by contracting indebtedness which was payable at shorter intervals or even on demand.

Atlantic Acceptance, beginning in Hamilton, Ontario in a small way in 1953, was a typical product of the sixth decade of the twentieth

century, a time of quite extraordinary economic expansion and prosperity in which it appeared that all the lessons of the pre-war depression years had either been forgotten or were discounted, because of the determination of governments to prevent their recurrence by making periodic increases in the supply of money. The company's record of profitability, as displayed in its published financial statements, was impressive; like all finance companies its ability to lend depended upon its ability to borrow, and to borrow on terms which would enable it to lend at a substantially higher rate than it had to pay for borrowed funds. The element of risk must be accepted in any such undertaking, but provision must also be made to protect it against loss in case the risks are unsuccessfully run. Lending institutions provide against the risk of non-payment by their debtors by setting up allowances for bad debts as a liability, or as a reduction in the amount of their reported assets; against the risk of not being able to repay their creditors they may provide reserves of cash or investment in easily realized investments, or sources of cash in the form of lines of credit from the banks. Finance companies, not being allowed by law to take deposits from the public, were originally entirely dependent upon these bank lines of credit: the banks, not being allowed by law to lend the huge sums placed at their disposal by depositors at more than a fixed rate of interest, were understandably reluctant to lend them to institutions not so handicapped. By borrowing money against the issue of obligations such as notes, finance companies were able to tap the rich resources of idle funds, held from time to time by large manufacturers, insurance companies and educational institutions, particularly in the form of pension funds, and to free themselves from their dependence upon the banks and the market for their own shares which had hitherto restricted their ability to lend. As going concerns in the 1950's their horizon seemed limitless, and even in the 1960's, when the occasional storm signal flew, the possibility of forced liquidation seemed to be comfortably remote. Thus the bank lines of credit, which provided the only real source of liquidity for an expanding finance company, were allowed to dwindle in proportion to the obligations which had to be met, and the accessibility of an expanding money market, in which the "rolling over" of these obligations was the rule rather than the exception, created a situation where liquidity, or the ability to pay one's debts in cash, was as scantly regarded as the gold standard.

The distinction between treating a company as a going concern and regarding it as in liquidation was frequently referred to by accountants in their evidence before the Commission, and in particular, by those who had been chiefly responsible for understating the allowance for bad debts reserved against the many large and imprudent loans made on the sole authority of C. P. Morgan, president of Atlantic Acceptance Corporation. That company, as a result of its default in the payment of

a mere \$5,000,000, suffered a fate which, it is fair to say, none of its competitors could have survived without large infusions of capital; all its secured obligations, amounting to over \$125,000,000 were, by operation of law, at once presented for payment. It is important to examine the degree of liquidity of its more than \$150,000,000 of assets which were charged with the payment of this debt. When a finance company gets into difficulties assistance usually comes from other companies, more fortunately situated, which are prepared to buy its shares, or at least, on the assumption they are of the quality generally prevailing in the industry, purchase its receivables at a price which would provide sufficient funds to meet the demands of its creditors; in the case of Atlantic it should be remembered that receivables were pledged with the trustee with an ostensible value of 115% of the face value of the issued senior notes. General Acceptance Corporation, an American finance company noted for its practice of salvaging faltering enterprises in the same field, was first on the scene after the Atlantic default, but, after a quick but penetrating examination of Atlantic's receivables, informed the trustee that, whereas at March 31, 1965 the allowance for bad debts had been shown in consolidated accounts as somewhat over \$2,000,000, and at June 17, with some measure of hindsight, as over \$6,000,000, the quality of Atlantic's loans, especially those made by some of its subsidiary companies, required an allowance of not less than \$38,000,000. By August 1965 the trustee, now receiver and manager by order of the court, estimated the amount realizable from receivables which Atlantic, as a going concern, had shown as worth upwards of \$160,000,000 in March, as only approximately \$110,000,000. Any possibility of General Acceptance Corporation, or any other purchaser, acquiring Atlantic Acceptance Corporation as a going concern accordingly disappeared, and the receiver and manager was compelled to embark upon a lengthy programme of liquidation calculated to meet only the claims of the senior noteholders in the order of 75¢ to 80¢ on the dollar.

Before its default Atlantic Acceptance had lines of credit from the Toronto-Dominion Bank for \$3,700,000, from the Royal Bank of Canada for \$2,000,000 and from the Bank of Nova Scotia, for its subsidiary Commodore Sales Acceptance, for \$750,000. The Toronto-Dominion Bank was its "lead bank" and had handled the general banking business for its sales finance operations since the company's incorporation. The line of credit for \$3,700,000 had been established in 1962, had been increased briefly in 1963 to \$5,000,000, and then restored to \$3,700,000 as a result of disquiet in the bank at the company's performance in 1962, and about some of its major loans. Although the bank permitted a "bulge" from time to time, it never increased its line of credit to Atlantic thereafter. This "bulge" was

stretched to the limit in the month immediately preceding Atlantic's default when, in spite of several warnings by senior officials of the bank, its indebtedness, in the course of much fluctuation, rose as high as $9,000,000; on June 14, 1965 their patience ran out. In fact Atlantic's bank lines were quite inadequate for the volume of business conducted by it and, since these were the company's sole source of liquidity, should have been more extensive. At June 14, 1965 it had upwards of $58,000,000 in short-term notes outstanding, of which $8,500,000 was payable on demand, $19,300,000 due within fourteen days and some $4,400,000 due within the next fourteen days. C. P. Morgan's desperate efforts to arrange long-term borrowing in New York, on which he was embarked when the blow fell, serve to emphasize the need for that type of accommodation; long-term funds are the complement of cash resources in the achievement of a proper standard of liquidity.

RECOMMENDATION I

1. *All finance companies should achieve and maintain a state of total liquidity.*
2. *Total liquidity should be defined as maintenance of cash and unused bank credit equivalent to short-term debt maturing at any time.*
3. *The maintenance of total liquidity should be ensured by*
   (a) *obtaining lines of credit from banks a substantial portion of which should remain unused, or*
   (b) *obtaining stand-by lines of credit from banks, paid for at a rate which will ensure their availability although not used in the normal course, as now provided to finance companies by banks in the United States of America, or*
   (c) *the maintenance of a portfolio of short-term investments readily convertible into cash, or*
   (d) *any effective combination of (a) (b) and (c).*

**Position of the Trustee as Receiver and Manager**

As a result of the default of Atlantic Acceptance on June 14, 1965, and the order placing it in receivership of June 17, 1965, the Montreal Trust Company, which was the trustee under all the deeds of trust securing the company's notes, became receiver and manager under the supervision of the Supreme Court of Ontario, a duty which it is still discharging. There is no doubt that, by applying for this appointment, the trustee made a prudent choice among the alternative remedies in the case of default provided by the trust deeds, which gave it discretion to select immediate liquidation by the sales of assets without providing for the further operation of the company's business. By concluding, however, as it was bound to do, that the realization of assets should be

devoted first to the redemption of the senior notes, it has exposed itself to litigation by holders of subordinated debt for which it is also the trustee. The litigation which seeks to establish the invalidity of a large portion of the notes issued by the company, and authenticated by the trustee, would no doubt have been begun in any event, but the situation which the trustee now finds itself in, embroiled as it is in the internecine disputes of its own beneficiaries under separate trust indentures, must be a source of embarrassment and concern. Since these difficulties could conceivably be multiplied in this and other similar cases, and since the interests of lenders at all levels of priority of debt should be represented by a trustee without other preoccupations in the same areas of responsibility, it would seem that a trustee under a trust indenture, securing the obligations of a borrower from the public, should not be exposed to even the most remote possibility of a conflict of interest.

RECOMMENDATION II

*No trustee should act as such under the terms of any trust indenture securing the obligations of a finance company on behalf of holders of those obligations if he is already trustee under the provisions of a trust indenture on behalf of holders of obligations which rank higher or lower in priority of claim upon its assets.*

**The Inflation of Income**

In all its published financial statements for the fiscal years ended June 30, 1954 up to and including December 31, 1964—as a result of a change in the year-end date there was a statement for the six-month period ended December 31, 1956—Atlantic Acceptance continuously reported a profit on its operations, rising from $14,700 in the first year to $1,100,004 in the last full year before receivership. The evidence before the Commission establishes the fact that C. P. Morgan, the president of the company, from the earliest period of its history personally intervened to ensure the reporting of a profit in each year, with a view to promoting the sale of the company's securities. He was himself a chartered accountant and thus familiar with the devices which might be resorted to to give a false appearance of profitableness to a company's operations, and resort to them he did. One of them peculiar to finance companies was the treatment of the pre-computed interest charge added to the principal sum secured by a conditional sales contract and spread over its life to provide equal monthly payments of blended principal and interest. The addition of the interest or service charge did not apply to small loans of $1,500, or less, made directly to the borrower and governed by the provisions of the Small Loans Act,[1] but these were not of great consequence in the Atlantic portfolio until 1963 and 1964; earlier, by far the greater part of its business consisted of the financing

[1]R.S.C. 1952 c. 251.

through dealers of purchases of automobiles and home appliances by taking assignments of the interest of the unpaid vendor. It was the practice of finance companies to take a portion of the charge at once into income, at the time when the assignment was made, to cover the cost of acquisition, and to defer the remainder as income to be taken up in subsequent periods, according to the calculation known as the sum-of-the-digits method or the "Rule of 78ths", showing this unearned interest as a liability on the balance sheet in the meantime. Atlantic never took less than 40% of the pre-computed interest charge into income as the cost of acquisition, out of which commissions to dealers were paid where dealers were involved, leaving it not less than 32% taken up at the beginning of the life of the contract; where dealers were not involved, as in the case of loans over $1,500 made directly to the borrower, the full 40% was taken up. Moreover, before the introduction of data processing equipment at the company's head offices in Oakville in November 1963, a simpler calculation was generally resorted to by taking a percentage of the outstanding accounts receivable for deferment of interest income to future years. This percentage, simply plucked out of the air by C. P. Morgan, varied from 6% to 6.9% of the outstanding receivables, and in effect increased the percentage of the pre-computed charge taken at once into income to some 60%. The 40% ratio was the highest employed by any finance company of stature in the industry and is now generally considered too high to be acceptable; in the period under review, indeed, the percentage employed by the more conservative companies was substantially lower, ranging from 7% to 25% of the pre-computed interest charge taken into income in the month of acquisition of the contract. The effect of increasing this ratio is to inflate profits by increasing current income at the expense of that provided for subsequent periods over the life of a conditional sales contract. One test, which may be usefully applied to show the distortion thus produced, is known as "the rebate test", and is based on the assumption that all borrowers offer prepayment of their loans at one time and at a certain date.[2] If the value at which these accounts receivable are carried on the company's books, plus any penalty exigible for prepayment, but minus the unearned interest deferred to subsequent accounting periods, is greater than the amount on the receipt of which the company is obliged to give a discharge, the balance sheet value of the receivable has been overstated and there is a deficiency in the unearned income account; if it is less, an adequate standard of conservatism has been achieved. The results of such tests, which incidentally reveal the percentage of the service charge taken up as income in the month of acquisition of the contract, are now often disclosed in the annual reports of the major finance companies, and as early as 1965 this was done by Industrial Acceptance

[2]Chapter XVII, pp. 1427-9.

Corporation Limited. Provision for such a test was provided for in the internal procedure manual of Atlantic Acceptance, but if it was ever generally applied its results were not reported, although the noteholders were supplied with an annual report containing "supplementary information" at December 31, 1963 and December 31, 1964 which included a brief reference to the fact that the cost of acquisition was 40% of the pre-computed charge. The shareholders, and the public generally, did not have this information.

Atlantic Acceptance has been described as a "crescendo" company; in other words its acquisition of new business and its reported assets constantly increased and, as long as new loan contracts were acquired at a greater rate than was necessary simply to replace the ones that expired, the penalty that might be exacted as a result of taking too liberal a percentage of the pre-computed charge at once into income could be indefinitely deferred, in spite of the fact that a reserve for unearned interest would be consistently too little, and the balance sheet value of the accounts receivable consistently overstated. But in a lean season the inadequacy of this provision would soon become apparent, and when Atlantic's house of cards did in fact come tumbling down, the real effect of thus overstating assets and inflating profits was starkly revealed. It will be seen from examination of the Canadian Sales Finance Companies Long Form Report, appended to the submission to this Commission by the Federated Council of Sales Finance Companies,[3] that this document, prepared as a result of joint consultation between the Federated Council and the Investment Dealers Association of Canada, provides a standard of disclosure far greater than any offered or contemplated before the Atlantic collapse. By a wise act of self-regulation these two associations have made the completion and provision of this form compulsory in cases where members of the Federated Council seek to borrow in the money market through members of the Association as intermediaries.

## Recommendation III

1. *Where a finance company adds to the principal amount of a loan made by it as pre-computed interest charge for the purpose of securing repayment of principal and interest in equal payments over the life of the loan contract, the percentage of such pre-computed charge taken into income at the commencement of the life of the contract, and not deferred as unearned interest to be taken into account as earned, should be disclosed in any report made to the directors and shareholders of the company or holders of any type of security for loans made to it, together with an explanation of the method by which unearned interest thereon is subsequently taken into income.*

[3]Appendix N.

2. *Regular rebate tests of the accounts receivable of a finance company should be made and their results clearly and adequately disclosed in such reports.*

**The Atlantic Structure**

Atlantic Acceptance Corporation owed its emergence from obscurity as a small local company in Hamilton, engaged in the financing of purchases of used cars and television sets, to the patronage of Lambert & Co., a Wall Street investment partnership formed by Jean Lambert in 1950. Lambert had, at the early age of twenty, come to the United States from France to escape from the onset of the German armies in 1940. His first partner was Alan T. Christie who, at the time of joining Lambert, was an assistant vice-president of the Bank of New York. As the result of an accidental meeting between Carman G. King, at one time New York representative of the Toronto investment firm of Gairdner & Co. and Carl Bastedo, a director of Atlantic, on the street in Hamilton, the affairs of Atlantic were brought to the attention of Christie whom King had known since their undergraduate days at the University of Toronto. In June 1955 Lambert & Co. bought the first issue of Atlantic debentures, convertible into common shares, for $300,000, and in 1958 sold them to a company in which it had previously acquired a substantial interest, known as Consolidated Toronto Development Corporation Limited, which owned valuable real estate, only partly developed, on the western outskirts of Toronto. The financial future of Atlantic was thus assured, particularly in 1959 when the United States Steel and Carnegie Pension Fund bought $2,500,000 of unsecured subordinated notes, together with shares and rights, making some $3,000,000 in all available to the company. This investment may in some measure be attributed to the friendship of Lambert and Christie with the president of the fund, Harvey Molé; the same may be said of that with James Niceley treasurer of the Ford Foundation, an institution which made a similar investment in 1961 and, at the time of default, held $2,000,000 in U.S. funds of the senior secured medium-term notes, 25,000 common shares and 45,000 second preference shares. A glance at the list of noteholders at Appendix E, particularly in the category of long-term debt, will show the effect of early investment in Atlantic securities by these two sophisticated lenders, who were followed by banks, insurance companies, universities, and religious and charitable foundations.

As Lambert & Co. tightened their hold upon Consolidated Toronto Development Corporation, which, after a complicated offering of rights, became Great Northern Capital Corporation Limited in 1964, using virtually the same name as Great Northern Capital Company Limited, a Lambert-controlled holding company which had distributed its assets

to shareholders in that year, so the subsidiary company increased its investment in the shares of Atlantic Acceptance Corporation which rose in 1963 to 49.6%, and in 1964 to 52.1% of those outstanding. It was through the Lambert firm that Kuhn, Loeb & Co. became fiscal agents for the sale of Atlantic securities in the United States, and enhanced their respectability in the eyes of American investors. The Lambert interests were already represented on the board of directors of Atlantic Acceptance, from the time when the first purchase of debentures was made and D. B. Mansur and A. C. Rooney, president and vice-president of Consolidated Toronto Development, were elected; subsequently Christie, Rooney and William H. Wallace, all directors of Great Northern Capital Company, were directors of Atlantic. Finally in 1965, as a reflection of the majority interest in Atlantic shares held by Great Northern Capital Corporation, five of the nine members of Atlantic's board were Christie, Wallace, Paul C. Sheeline, another Lambert partner, Jacques Kayaloff and James E. McConnell. In addition, C. P. Morgan himself had the complete confidence of the Lambert partners; to the day of default he was regarded as their man.

Lambert & Co. were by no means disposed to underestimate the importance of their Canadian investments which represented the greater part of their portfolio. The firm had been formed with the making of capital gains principally in view. Great Northern Capital Company had originally been known as Great Northern Gas Utilities, and had represented a joint venture between Lambert & Co. and Williams Brothers Company, an American petroleum engineering firm. As a result of the re-organization in June 1964 they went their separate ways, and Lambert & Co.'s Canadian enterprises were chiefly in the field of real estate development, consisting of Great Northern Capital Corporation, which as Consolidated Toronto Development had been 99% owned by the wound-up Great Northern Capital Company, and Western Heritage Properties Limited, a subsidiary company which, like its parent, was chiefly engaged in real estate development in Ontario and Pennsylvania, with another enterprise near Edmonton, Alberta. Great Northern Capital Corporation in 1965 increased its interest in Atlantic Acceptance to 53% of the common stock; at December 31, 1964 the investment, which at that point represented 52.1%, was carried on its books at $5,220,450 and had a market value of $7,134,300. Furthermore, at June 17, 1965 Great Northern Capital Corporation had $300,000 in Atlantic short-term senior notes, its subsidiary, Home Smith Properties Limited, $900,000, and its subsidiary, Humbria Limited, $50,000, all in Canadian funds, while Lambert & Co. themselves held a similar note representing a loan of $500,000 in U.S. funds. Since at that date Lambert & Co. and Lambert International Corporation, a company in which the Royal Bank of Canada and Morgan Guaranty Trust Company participated, held a dominant interest in Great Northern Capital Cor-

poration, it is clear that the Lambert partners were deeply and genuinely involved in the fortunes of Atlantic Acceptance, and were optimistic about its future.

Itself a subsidiary, Atlantic Acceptance had subsidiaries of its own. The head office of the company was at Oakville, Ontario, midway between the cities of Toronto and Hamilton, and from there the following companies operated in the manner indicated.

(1) *Atlantic Acceptance Corporation Limited,* the parent company, incorporated on January 28, 1953 as a public company in Ontario, carried on the business usually known as sales financing through the purchase of conditional sales contracts from dealers and making "wholesale" loans on the security of inventory, usually to dealers supplying the conditional sales contracts;

(2) *Atlantic Finance Corporation Limited,* a subsidiary, incorporated in Ontario as a public company on February 22, 1956 made most of its loans direct to borrowers, a substantial portion of which in later years were of $1,500, or less, and the terms of which were governed by the Small Loans Act of Canada;

(3) *Atlantic Acceptance (Toronto) Limited,* was a private Ontario company, incorporated November 22, 1960, also a subsidiary and created to hold mortgages of real estate;

(4) *Pay As You Study Plan Limited,* a subsidiary, was incorporated as a private Ontario company on November 12, 1959 to make loans to students;

(5) *Concourse Agencies Limited* was a subsidiary incorporated as a public Ontario company on October 23, 1959, created with a view to financing credit card purchases, and subsequently acted as a collection agency.

All of these subsidiaries were wholly-owned by Atlantic Acceptance Corporation, but Pay As You Study Plan and Concourse Agencies were at the date of default inactive, nor had their operations ever been significant. Two subsidiary companies operated independently in Toronto as sales finance companies, having been acquired, rather than created by Atlantic Acceptance.

(6) *The Premier Finance Corporation Limited* was a public Ontario company incorporated on March 7, 1929, and wholly acquired by Atlantic Acceptance on February 18, 1959 from Clarence F. O'Neill, otherwise known as C. Frank O'Neill, who continued to manage it and to conduct his own business on its premises under the style of O'Neill Finance Company; Premier's business was mainly that of financing retail purchases of "hard" and "soft" goods; and

(7) *Standard Discount Corporation Limited,* incorporated in Ontario as a private company on June 18, 1949, and acquired by Atlantic Acceptance on October 28, 1961 from Samuel and Arthur Baker, who continued to manage its business of financing sales by retail merchants, largely in the "soft" goods area.

Of a different order were three companies, personally operated by C. P. Morgan from the executive offices of Atlantic Acceptance situated in the Concourse Building at 100 Adelaide Street West in Toronto, referred to in this report as the Adelaide Street companies. These were

(8) *Commodore Sales Acceptance Limited,* an Ontario private company incorporated on March 4, 1959, the common stock of which was held by Atlantic Acceptance, as to 51% from July 13, 1959 and 100% from April 25, 1961;

(9) *Commodore Factors Limited,* a subsidiary of Commodore Sales Acceptance, incorporated in the State of New York on January 9, 1961 and wholly-owned, and

(10) *Adelaide Acceptance Limited,* incorporated as a private company in Ontario on June 30, 1958 as Crest Acceptance Corporation Limited, and wholly acquired by Atlantic Acceptance on March 8, 1962, the name being changed on April 25 of that year.

The lending business of these companies was varied and required large loans made to them by Atlantic Acceptance itself. The use of the word "acceptance" in the case of two of them was misleading, since none of the companies did the type of sales financing to which this term is commonly applied. Commodore Sales Acceptance, which was originally designed to factor the accounts receivable of Commodore Portable Typewriter Limited, later to be known as Commodore Business Machines (Canada) Limited, and its New York subsidiary did a substantial factoring business, which involves the sale or assignment of accounts receivable to the person described as the factor for a discounted purchase price, or loan, whereby the purchaser or borrower, as the case may be, obtains cash and is relieved of the task of collection. All three companies made large capital loans against the pledge of inventory and equipment, and sometimes secured by debenture, but the nature of the security taken for loans varied considerably, in some cases represented merely by notes and, occasionally, only by entries in the books of account. These companies put into execution Morgan's theory of "secondary banking", and, where they dealt systematically at all, dealt with borrowers who had become unable to obtain, or to increase regular bank loans, and were willing to pay exceptionally high rates of interest. It is with the lending operations of these companies that the preceding pages of this report have been mainly concerned.

No attempt will be made in this summary to give a condensed account of the various loan transactions undertaken by these companies; these are sufficiently difficult to understand, because of their complexity as already described, without making them incomprehensible by further condensation. Nevertheless certain general observations must be made about them for, together with a satellite company, Aurora Leasing Corporation Limited, their position in the Atlantic complex, under the untrammelled direction of C. P. Morgan, provides the key to any explanation of the Atlantic failure and the huge monetary loss which attended it. In its first and preliminary review of the Atlantic situation after default the receiver and manager reported to the noteholders on August 18, 1968 that, out of total Atlantic receivables of some $150,-000,000, approximately $51,400,000 belonged to the Adelaide Street subsidiaries, with respect to which it would be prudent to reserve for losses something in the order of $34,000,000, saying, "in almost all cases the outstanding loan exceeds the apparent value of the borrowing company or the value of any specific collateral or security which can be realized". The largest single debtor of the Adelaide Street group was Aurora Leasing Corporation which owed them a total of $12,500,000, $10,000,000 to Commodore Sales Acceptance from that company's total of $35,720,000 and $2,500,000 to Adelaide Acceptance, representing the greater part of that company's receivables of $4,778,000. Aurora Leasing was not a subsidiary of Atlantic Acceptance which held none of its shares; its largest shareholders were British Mortgage & Trust Company and that company's president Wilfrid P. Gregory, Q.C., holding 35% between them, and the trust company, at the date of Aurora Leasing's bankruptcy on July 30, 1965, had advanced to it $1,980,000 on its unsecured notes. Aurora Leasing had been acquired by C. P. Morgan and his closest associates, William L. Walton and Harry Wagman, practising as chartered accountants in Toronto under the firm name of Walton, Wagman & Co.; so closely were these three associated in many transactions, mostly dishonest and undertaken at the expense of Atlantic Acceptance, that they have been referred to generally as the Trio, a sobriquet conferred by Wagman himself. The company's lending operations, conducted for the most part with Atlantic funds advanced through Commodore Sales Acceptance and Adelaide Acceptance, were controlled entirely by C. P. Morgan from the offices of Walton, Wagman & Co., who kept its books and were its auditors. Although ostensibly Aurora Leasing conducted a business of leasing equipment as its name implied, and leased to Atlantic Acceptance itself the equipment and furniture of its offices, its main preoccupation was the making of large capital loans to borrowers selected by Morgan, in many of which he and his associates held an interest. In this respect

its operations resembled those of the Adelaide Street subsidiaries. Although Morgan had substantial shareholdings in Aurora Leasing, he was neither an officer nor director, and British Mortgage & Trust was not represented on its board; but three out of the five directors were Morgan's nominees.

**Extent of the Loss**

When the evidence of Mr. J. G. Haxton, vice-president of the Montreal Trust Company, was given to the Commission in March of 1966, he and his staff had acquired a further six months' experience of the quality of the assets of the Atlantic group of companies. It appeared that the accounts receivable of the parent company left much to be desired, particularly in the case of wholesale and capital loans made to automobile dealers, representing 14% of the whole, and in that of the category of "large loans" which represented a further 14%. Those of Atlantic Finance Corporation were in all respects the soundest, and Standard Discount Corporation seemed also capable of standing on its own feet, although handicapped by having been compelled to take over a large portion of the receivables of the Premier Finance Corporation, which had ceased to lend in 1964, and the affairs of which were heavily embarrassed by slipshod procedures, inadequate records and a large debt of $788,500 owed to it by Racan Photo-Copy Corporation Limited. Racan, like Aurora Leasing, was placed in bankruptcy. By this time the Clarkson Company Limited, trustee in both these bankruptcies, as in many others which were created by the efforts to collect money owing to the Atlantic companies, had made a detailed examination of the accounts receivable of the Adelaide Street subsidiaries, with a view to estimating recovery of the very large amounts of Atlantic money which had been advanced to borrowers through them. Haxton was accordingly able to conclude that the shareholders' equity had been entirely wiped out, and that the estimated recovery would only be sufficient to pay something in the order of 75¢ to 80¢ on the dollar on the debt owing to the senior noteholders, leaving nothing for those in the subordinated and junior subordinated position. At the time, his estimate of the loss was something between $50,000,000 and $64,000,000, and it now appears, in the light of subsequent developments, that $65,000,000 would be a conservative estimate; this might well exceed $70,000,000, depending upon what is ultimately realized from the sale of the Lucayan Beach Hotel group of buildings on Grand Bahama Island, in the construction and operation of which Atlantic Acceptance had invested $10,000,000 before the collapse, to which must be added an additional $3,000,000 spent by the receiver and manager to acquire control of the hotel company, and additional large sums to put the property in order

and defray the cost of an unprofitable enterprise, which only now is showing some signs of being able to make money. To this must also be added the expenses of the receivership in so far as they are represented by compensation awarded to the receiver and manager, including that of the Clarkson Company which it employed as liquidator, and legal fees and disbursements, which at the end of 1968 amounted to $2,-209,770. The loss to British Mortgage & Trust Company, due to its commitment of upwards of $12,000,000 to investment in securities and loans to individuals and corporations of the Atlantic complex at the instance of its president Wilfrid P. Gregory, himself a director of Atlantic Acceptance and a close associate of C. P. Morgan, must be estimated at between $6,500,000 and $7,000,000, subject to imponderable considerations such as still affect any estimate of the loss to Atlantic itself. No attempt has been made to estimate the loss to other creditors of individuals and companies, indebted to Atlantic Acceptance and its subsidiaries, as a result of twenty-one bankruptcies precipitated by the process of collecting their debts; though this would have been an interesting study, it would have immensely enlarged the work of the Commission, delayed the production of its report and, in the end, proved to be imprecise. By taking a step much further into the realm of speculation, the Commission might have endeavoured to assess the monetary value of the loss occasioned by the breakdown in the confidence of investors, and other sections of the public, in Canadian finance companies seeking to borrow in the money market, which for the balance of 1965 and throughout 1966 was virtually closed to them. It might have involved an attempt to assess the economic effects of loss of confidence, and indeed loss of opportunity for investment and re-investment, not only of the funds locked up by the receivership of Atlantic Acceptance, but of those which dried up as a result of its collapse; this would have required studies far beyond the range of the Commission's terms of reference and, perhaps, a premature attempt to detect results not yet discernible. But taking the loss of Atlantic Acceptance and its subsidiary companies and of British Mortgage & Trust Company, together with the costs of the receivership of Atlantic Acceptance, estimated on a conservative basis, a figure between $70,000,000 and $75,000,000 is clearly in view.

In the case of Atlantic Acceptance the loss fell on the shareholders and noteholders, as already seen, subject to the prospect of substantial recovery by holders of the senior secured notes, albeit after a period of waiting which has already lasted four years. It may be said that the greater part of this fell upon investors of such financial strength that no real hardship was created, and as Mr. J. N. Abell's report[1] indicates, these investors were not unduly disposed to blame Canadian standards of disclosure or any misrepresentation by the company itself as reasons

[1]Chapter XIX.

for making their investments in the first place. Only one class of noteholders, those of the $4,500,000 6¼% long-term subordinated notes—first series, could be described as small investors, and the names of the registered holders only, representing somewhat less than a fifth of the whole issue, are disclosed in the trustee's list.[2] Almost all of these registered noteholders appear to have invested small amounts, and to have been individuals and small estates widely scattered across Canada; if they are representative of holders of the whole issue, including the coupon-bearing notes, considerable hardship was inflicted. Of the 699,718 common shares outstanding on June 17, 1965 Great Northern Capital Corporation and its subsidiaries had 363,750, and 239,064 were held by corporations and partnerships all holding more than 1% of the issued stock, leaving 96,904 shares for holders of smaller amounts and therefore more widely distributed; this last amount was probably augmented to the extent that two firms of stockbrokers and British Mortgage & Trust Company included in their holdings shares allotted to customers' accounts. Although the first preference shares, amounting in all to 14,505, were quite widely held in small amounts, and the 190,000 second preference shares series "A" about equally divided between large and small investors, all of the 10,000 second preference series "B" shares were owned by the Connecticut General Life Insurance Company and the 10,000 third preference shares outstanding at June 17, 1965 were held by nominees of the United States Steel and Carnegie Pension Fund.

The loss of British Mortgage & Trust Company fell principally on its shareholders whose stock dropped from a price of $30 per share, at the time of Atlantic's default, to about $10 when the news of its involvement with Atlantic became generally known in July 1965, until it was finally exchanged on the basis of six shares for one of Victoria and Grey Trust Company, when British Mortgage & Trust merged with that institution as the result of an agreement reached at the end of the month and confirmed by order-in-council on September 30; the exchange of shares created a contemporary value for British Mortgage stock of $2.50 per share. Significant but smaller losses in the order of $660,000 were suffered by estates, trusts and agencies under the administration of the trust company through their investment in the securities of Atlantic Acceptance, and particularly as a result of it selling its company holdings before those of the estates, trusts and agency account. That no depositors or holders of guaranteed investment certificates suffered may be attributed to the action taken in July 1965 by the Government of Ontario in guaranteeing loans by chartered banks to British Mortgage & Trust in the amount of $3,000,000, which were not in fact advanced since the heavy run on deposits was halted by this assurance of support.

[2]Appendix E.

**Analysis of the Loss in the Atlantic Group of Companies**

The question which immediately occurred to the public when the full extent of these staggering losses became known was: what happened to the money? This was the question which the Commission had to answer, since the necessary inquiry must lay bare both the causes and effects of the sudden collapse of Atlantic Acceptance Corporation as the result of default in payment of a debt which, though not negligible in itself, was not considered, even by close observers at the time, to be of deadly significance, and would not in the normal course be expected to cause the ruin of a company having over $150,000,000 in assets, and having shown itself to be profitable in every fiscal period since it started business. True, as already seen, its position had lacked liquidity at a season when short-term money was increasingly difficult to find in the United States. True, an event of default under the provisions of trust indentures almost invariably makes all the debts secured thereunder payable at once, and this default was no exception. True also, that a company with only twelve years of experience in the finance business may take risks and accept security, in its struggle for a place in the sun, which the giants of the industry would disdain. Yet why had the assets of Atlantic Acceptance, as reported in its consolidated financial statements, audited by highly reputable chartered accountants, not been able to meet the test of realization and over a third of them vanished into thin air?

Since this was clearly an accounting problem, Mr. John A. Orr, F.C.A., financial and auditing adviser to the Commission was instructed by its counsel, Mr. A. E. Shepherd, Q.C. to conduct an examination of the accounts receivable of the Atlantic group of companies from the point of view of auditors newly-engaged to audit the accounts of Atlantic Acceptance Corporation and all its eight subsidiary companies, on the supposition that they were going concerns, not in liquidation, and using only information available at the time, for the fiscal year ended December 31, 1964, and for that immediately preceding it which ended December 31, 1963, in accordance with generally-accepted auditing procedures, and with a view to establishing a proper allowance required for bad debts. The verification of such an allowance would be the first concern of accountants auditing accounts for a finance company, but in this case great care was necessary, and was taken by Mr. Orr and members of the firm of Touche, Ross, Bailey & Smart who assisted him, to exclude from their minds all consideration of the ultimate fate of these companies, and what was subsequently discovered about the nature and quality of many of the loans that had been made. The method and results of this exercise have been fully discussed in Chapter XVII and the reports presented to the Commission included as Appendix H and Appendix J; the barest summary must suffice here. At December 31, 1963, out of accounts receivable reported as assets in the consolidated financial

statements, less amounts payable to dealers held back and unearned interest treated as deferred income amounting to $83,947,669, the allowance provided in the financial statements was $1,747,176, but in Mr. Orr's opinion an additional allowance of $8,672,381 was required. At December 31, 1964, the effective date of the last published financial statements before default in 1965, in respect of accounts receivable calculated on the same basis amounting to $123,400,216, the allowance provided in them was $2,723,314, and the additional allowance required was $18,533,056, or a total allowance for bad debts of $21,256,370, some 16% of the receivables outstanding. This evidence which I accept, and which gave the benefit of any doubt to the position taken by the management of Atlantic Acceptance at the period under review, showed where the most serious weakness lay. It was remarkable in that the need for increasing allowances for bad debts at both dates was only observed in the case of the statements of four out of the eight companies, and these were Commodore Sales Acceptance, Commodore Factors, Adelaide Acceptance and the Premier Finance Corporation. Orr said that he would have come to much the same conclusion as the company's auditors as to the proper allowances in the case of Atlantic Acceptance Corporation, the Oakville subsidiaries, and Standard Discount, although, after the receiving order was made on June 17, 1965, the receiver and manager, looking at the situation from the standpoint of liquidation, had serious reservations about the quality of the receivables of the parent company itself.

Here then was a considerable part of the explanation for the disappearing assets; they were heavily overstated as a result of the understatement of the allowance for bad debts which was deductible from them, and this overstatement, when taken into account at the end of 1963 and 1964, required corresponding adjustments to the shareholders' equity and statements of earnings. For 1963 shareholders' equity reported as $9,614,604, after correction for the provision of an appropriate allowance for bad debts, and adjustment of provisions for income tax for the current and previous year, should have been $1,798,111; thus the reported consolidated net income of $814,403 becomes a loss of $7,516,708. For 1964 the shareholders' equity, reported in the published financial statements as $15,906,163, should have been shown as non-existent, a deficit recorded of $1,482,365 and the reported profit of $1,100,004 a loss of $16,629,794. In short, the financial statements for these years were misleading and the reported profits fictitious.

A further survey conducted by Mr. A. W. Moreton, C.A. of the same firm, and about which he also testified to the Commission, showed that by arbitrary transfers of income in the form of management fees and profit derived from interest on loans payable to Atlantic Acceptance by Commodore Sales and Adelaide Acceptance, on a much greater scale, be it said, by the former than by the latter, the parent company was

made to appear profitable when actually it was not. These transfers were made at the direction of C. P. Morgan himself with a view to producing this illusion, and the same was true in the case of Premier Finance Corporation under the complaisant management of O'Neill. The percentage of total assets used by these companies was greatly exceeded by that of their reported earnings, and the final picture, on consolidation of the accounts, in consequence misleading. Had it not been for this employment of the Adelaide Street subsidiary companies and Premier Finance, and if, indeed, they had not existed, the earnings of Atlantic Acceptance would have been shown to have declined from 1960 to 1961, to have amounted to losses in 1962 and 1963, and to have achieved a profit in 1964 only because of the performance of the Oakville subsidiary Atlantic Finance Corporation, the profits of which in that year were substantially inflated by its practice of taking 40% of the pre-computed interest charge on its loans over $1,500 into income forthwith as the cost of acquisition of the individual contract. Since the ability of Atlantic to borrow successfully in the money market, and to attract capital investment, depended upon the favourable appearance of its consolidated financial statements, the inference is plain that the misrepresentation of the company's position in these documents created by the understatement of the allowance for bad debts was deliberate, designed to encourage purchase of the shares and notes of the company, and therefore constituted fraud.

Whereas the Commission's accountants had conducted their test of the accounts receivable of the Atlantic companies as if they had been engaged to audit all of them, the actual circumstances of Atlantic audits had been different. From the beginning of its existence, and for ten years thereafter, the auditors of Atlantic Acceptance had been the Hamilton firm of Wright, Erickson, Lee & Macdonald who owed their engagement to the personal friendship of C. P. Morgan and their senior partner, Harold P. Wright. They had also been engaged to audit the subsidiary companies as they emerged, beginning with a small finance company in St. Thomas, Ontario, which Atlantic had acquired and subsequently wound up, and the Oakville companies with the exception of Pay As You Study Plan and Concourse Agencies. The accounts of these, together with those of the Adelaide Street companies, Commodore Sales Acceptance, Commodore Factors and Adelaide Acceptance had been audited throughout by Walton, Wagman & Co. and their successors, Wagman, Fruitman & Lando, who took over the business of the former when W. L. Walton was indicted for income tax fraud in 1964. On June 30 of that year, in response to repeated suggestions over several years by Alan T. Christie, Morgan agreed to the replacement of Wright, Erickson & Co. by Deloitte, Plender, Haskins & Sells. Christie's position in the matter was that Atlantic by then was sufficiently important to require the services of "a national firm" having offices throughout Canada and

important affiliations in Britain and the United States. This firm were also auditors for Great Northern Capital Corporation, of which Atlantic Acceptance was a subsidiary by the end of 1964, a fact which probably supplied the *arrière pensée*. Owing to the elusiveness of C. P. Morgan the Deloitte partner in charge of the Atlantic audit, Mr. J. G. Duncan, F.C.A., was not able to discuss its scope or programme with him until October, and only then learned that the Adelaide Street subsidiaries, with Premier Finance and Standard Discount, would remain in the hands of other auditors, as they had from the time of their creation or acquisition. For reasons given in Chapter XVII, and in accordance with apparent Canadian practice, Deloitte, Plender & Co. did not examine the working papers of Wagman, Fruitman & Lando dealing with their audit of these subsidiaries, and made no reference in their report on the consolidated accounts to the size of the assets employed by them in proportion to those that were consolidated, but said simply that with respect to financial statements of certain subsidiary companies, which they did not identify, they had relied on the opinion of other chartered accountants which they did not name. In this they followed the practice, with minor variations, observed by Wright, Erickson & Co. in previous years, and the evidence before the Commission is generally to the effect that this was acceptable at the time.

Christie testified that it had not crossed his mind, until he saw the auditors' report on the consolidated Atlantic accounts for the year ended December 31, 1964, that Deloitte, Plender & Co. would not audit the separate accounts of the Adelaide Street subsidiaries. This statement was made on oath and does not reflect favourably either on his recollection or judgment, since Morgan had steadily resisted in previous years the attempts made from time to time to replace Walton, Wagman & Co., and explicit instructions from the board of directors were evidently required. In any event it is clear that no such instructions were given by the Atlantic directors to make a change which might have been expected because of the clouds which had gathered over the head of Walton himself. Later the board of directors of Great Northern Capital Corporation, of which Christie was president, contemplated legal action against Deloitte, Plender & Co. for damages arising out of their failure to examine or disclose the true state of the affairs of the Adelaide Street companies; they did not proceed, and it is difficult to see how such an action could have succeeded. In view of the practice which prevailed and was acceptable at the time, it would seem that Deloitte, Plender & Co. were entitled, as auditors of the consolidated accounts of the parent company, to rely upon the opinion of auditors about which nothing discreditable was known, and they were not bound to make the enquiries which prudence, certainly, and even common sense would evidently require; but in failing to do so they ignored the advice of their own internal procedure manual which was based on stricter American standards, and

thus lost the opportunity of learning from the Institute of Chartered Accountants of Ontario that disciplinary measures had been taken against W. L. Walton and his then partner William Wagman, a brother of Harry Wagman, in 1962. Since W. L. Walton and Harry Wagman were the close and indispensable partners of C. P. Morgan in rendering unqualified opinions on the financial statements of the Adelaide Street companies, which concealed from the directors of Atlantic Acceptance, and the public generally, the worthlessness of much of their assets, this oversight could not have been more critical if it had been deliberately contrived.

Two things, indeed, were essential to the success of Morgan's scheme; the auditors of the Adelaide Street subsidiaries had to be his confederates and the primary auditors kept at a safe distance. Morgan, himself a chartered accountant, reacted sharply to a suggestion by the Deloitte firm that their auditors' report should mention the names of the subsidiary companies of which they were not the auditors, refusing to consider such a proposal because it was not Canadian practice, a contention with which Duncan had to agree. If, for instance, either Wright, Erickson & Co. or Deloitte, Plender & Co. had audited the accounts of Commodore Sales Acceptance and Adelaide Acceptance, they would have been confronted with the fact that the Wagman firm were also auditors of a large number of these companies' debtors, in particular Aurora Leasing Corporation which was the largest, and would have been bound to enquire into the state of that company's accounts receivable, and the adequacy of its allowance for doubtful accounts which was virtually non-existent. Since the collapse of Atlantic the views of the accounting profession, as propounded by the Canadian Institute of Chartered Accountants, in company with those of other governing bodies in the English-speaking world, have altered to reflect the opinion that the primary auditor should take more responsibility for the auditing procedures applied by the auditors of subsidiary companies, or secondary auditors as they are sometimes called. The final determination of what can be described as a polite controversy, cautiously undertaken and replete with hair-splitting refinements, has yet to be declared, even after the lapse of four years, and it is perhaps time that public regulatory authorities concerned themselves with this vital aspect of the preparation of published financial statements.

RECOMMENDATION IV

*When the financial statements of a finance company and those of any subsidiary company are consolidated for the purpose of making a report on the financial situation of a finance company to its shareholders, and auditors other than those engaged to audit the accounts of the finance company are engaged to audit those of its subsidiary company, the auditors expressing an opinion upon the consolidated financial statements*

*should rely on the work of other auditors only to the extent that they take responsibility for it, as if the relationship between them were that of principal and agent.*

If, in addition to the consolidated financial statements of the Atlantic group, the shareholders and the public generally had been able to see the financial statements of Atlantic's subsidiary companies and the parent company considered as separate units, including, as now required by the 1966 amendments to the Corporations Act of Ontario, a statement of source and application of funds, they would have had at least the means of knowledge of the situation as it existed, with the proportion of the total assets of the group used by the subsidiaries, transfers of income to the parent company by them and other information, which would have enabled the trained analyst to provide investors with significant information about the operations of the group. In the case of finance companies, now frequently acquiring majority interests in companies which are not engaged in regular finance company business, it would therefore be desirable if the financial statements of subsidiary companies were included in the annual report as a supplement to the consolidated financial statements. It is also desirable, for the purposes of consolidation and indeed for reporting generally, that the financial year of a subsidiary company should end on the same date as that of its parent, unless there are sound reasons, such as operation in a foreign jurisdiction, for not observing a uniform fiscal period.

Recommendation V

1. *Where the annual financial statements of a company or companies subsidiary to it are consolidated with those of a finance company, its annual report to the shareholders should contain the financial statements of both or all of them, separately reported upon by their auditors.*

2. *The fiscal years of a finance company and any company subsidiary to it should be coterminous in date, unless sufficient reason is shown for a different treatment and clearly explained in a note to the consolidated financial statements.*

This having been said about the vital accounting and auditing aspects of the Atlantic losses, dealt with in detail in Chapter XVII, a return must be made to the question stated at the beginning of this section. The accountants' investigation, and the evidence which they produced before the Commission, dissipated the illusion of profitability, rapidly mounting assets and compliance with the terms of the deeds of trust, which Morgan had created to enable Atlantic Acceptance to sell its securities and borrow large sums from the public. This however is only

one face of the coin. The money was borrowed and it was lent. All but a relatively small fraction of what was lost to the company's creditors went back into the economy in one way or another. I have endeavoured in this report to discover the ultimate destination of all of it which found its way into the hands of C. P. Morgan and his associates, according to the available evidence, and I have indicated those areas where the evidence is of doubtful value, or simply non-existent because of the peculiar benefits conferred on dishonest men by "tax havens" such as Switzerland and the Bahama Islands. For the rest, examples abound of great ingenuity displayed in devising methods of purloining Atlantic money only to invest it in business ventures of astonishing folly, operated by either incompetents or thieves. Millions of dollars were lent to such enterprises as Frederick's Department Store, D.H.I., Symphony Paint, General Spray Service, the Groship companies and others, the affairs of which have been examined, only to be spent recklessly in operating businesses which never had any chance of success. The answer to the question, "where did the money go?" must be that in general it went to purchase, for example, the inventory of Frederick's or aluminum for the windows of D.H.I. and, above all, to make good the staggering losses sustained by such enterprises which had shown from the beginning that they had no economic right to exist. Having once begun on a lending policy which was unsound in every sense, except that of yielding hidden and dishonest profits to him and his fellow-conspirators, Morgan was caught in a current from which there was no escape until it had finally swept him into the abyss.

### The Responsibility of C. P. Morgan

The preceding chapters of this report inevitably lay stress on transactions in the history of Atlantic Acceptance Corporation which were questionable, improper and in many cases unlawful. Nevertheless, it must be borne in mind that, throughout its life of twelve years, a substantial part of its operations was conventional, that it and its subsidiaries employed a large number of people who faithfully discharged their allotted tasks and who, as a result of the company's failure, lost their livelihood, their entitlement to pension and the opportunity for re-employment on terms commensurate with what they had previously enjoyed. Moreover, the waves of disillusionment and distrust which spread outwards from the company's engulfment carried with them dislocation and disaster to many enterprises that deserved a better fate. The important part played by sales finance companies in the economy of the nation should not on this account be underestimated; these companies were virtually untrammelled by legislative restrictions and, compared with the chartered banks, took risks in lending which have been generally justified, and which have

made an important contribution to the expansion of the economy. Morgan's idea of "secondary banking" was not in itself contemptible, although far too many of the borrowers from the Adelaide Street companies were imprudently or incompetently managed; too many found that high interest rates, the capitalization of repayments in arrears and the rewriting of loan contracts saddled them with an impossible burden of debt, and too many that, as a result of their borrowing, they had unintentionally acquired partners in the persons of Morgan, Walton or Wagman. From the earliest days of the period with which this report has been concerned the activities of C. P. Morgan, prosecuted with considerable energy and ingenuity as they were, have been shown to be dishonest. Without his successful application of dubious accounting devices it is unlikely that Atlantic would have survived its first two years of operation, and later have attracted the favourable attention of the Lambert firm. The International Silver Company, which had employed him in Hamilton and Niagara Falls, was reticent about, and was probably never asked to reveal its intention to dismiss him in 1958 as a result of his handling of one of its debtors, which first brought him into contact with W. L. Walton, its trustee in bankruptcy. In any event the circumstances of his departure from the employment of that company were concealed by the determination of Lambert & Co. to have him as president and full-time manager of Atlantic. A characteristic piece of effrontery may well have disarmed the Lambert partners; Christie testified that Morgan applied to and was granted permission by the Atlantic board to accept an invitation to remain a director of International Silver after leaving that company's employ which, not surprisingly, never materialized.

Morgan let no grass grow under his feet after he had taken over full-time management of Atlantic Acceptance at the end of 1958. The year 1959 was climactic; it not only saw the critical long-term investment in the company by the United States Steel and Carnegie Pension Fund, but the creation of Commodore Sales Acceptance as an instrument for the lending of Atlantic money to borrowers selected by Morgan himself, in a manner which would escape the surveillance of the Lambert directors and particularly of D. B. Mansur, president of Consolidated Toronto Development Corporation, whose integrity and acumen Morgan had reason to fear. Morgan had been authorized by the Atlantic directors to implement his own suggestion of acquiring a factoring company; he matched this opportunity with that of participating in Commodore Portable Typewriter, the fledgling enterprise of Jack Tramiel and Manfred Kapp in whom he recognized valuable qualities. Instead of buying a going concern he created Commodore Sales Acceptance and, after a brief interval, caused Atlantic to buy 51% of its shares, while the remaining 49% were placed at the disposal of himself and his associates

through issues of convertible notes, Morgan himself using Atlantic money to finance the acquisition of an interest by Tramiel and Kapp which enured to his own benefit. When, in 1961, he persuaded the Atlantic board to acquire the minority interest in its own subsidiary, all the minority shareholders made a profit, including Carman G. King of Annett & Co. and three Atlantic directors, Christie, Gregory and Wallace who, according to the minutes, declared their interest and refrained from voting. Characteristically, Morgan's profit was made secretly and his interest not declared. Then, in 1960, he acquired Aurora Leasing Corporation with a combination of its own and Atlantic funds, in a transaction which yielded substantial profits to the Trio, and in 1962 Crest Acceptance was bought by Atlantic and became Adelaide Acceptance in another which was modest enough, but yielded the Trio a 40% profit, secretly and dishonestly obtained through a nominee. Such was the manner of the creation of these indispensable adjuncts to Morgan's future plans for his own enrichment, plans to which Walton, Wagman, Tramiel and Kapp were privy and which enriched them also. The method which Morgan used was simple enough. In the Trio operations Atlantic funds were advanced by Commodore Sales Acceptance, often through Aurora Leasing, which provided additional concealment to the transactions, to borrowers in which they had an interest, such as John Belli Operations Limited, Frederick's Department Store Limited or Conarm Developments ~~Limted,~~* or to companies which they wholly owned like Yarrum Investments Limited, Dallas Holdings Limited and Valley Farm and Enterprises Limited. The transactions and the means taken to conceal them were complicated, and executed with all the ingenuity that experienced accountants could employ; their complexities have been dealt with, as faithfully as time and space permitted, in Chapters V to XIV of this report, sometimes isolated but more frequently interwoven with the affairs of Commodore Business Machines, the Lucayan Beach Hotel Company and other principal users of Atlantic loans. Even in the case of Racan Photo-Copy Corporation, the history of which, with that of its promoter Elias Yassin Rabbiah, is shot through with clearly criminal activity, Morgan made a clandestine investment in its shares by participating in that of his favourite solicitors, Carl M. Solomon and Irwin Singer, but denied on oath that he had ever been a shareholder; it seems that his conscience was appeased by the fact that he had never been the registered owner of the certificates.

Contemporaneously with the acquisition of Aurora Leasing Corporation by the Trio in the autumn of 1960, another company, called N.G.K. Investments Limited, was incorporated which, like Aurora, issued convertible notes and shares. The evidence is that the name was originally intended to be "M.G.K." representing Morgan, Gregory and King; at first the two largest shareholders were Morgan and British

Limited

Mortgage & Trust Company, but eventually the trust company held 20% of the shares, Gregory and his wife 12%, Morgan 8% and King, Walton and Wagman 7% each, with the balance distributed to other persons who were also, by and large, shareholders of Aurora. Apart from the sale of its securities, this company was principally financed by two loans of $250,000 each from Commodore Sales Acceptance and British Mortgage & Trust, but received temporary loans of Atlantic money from time to time as occasion required. N.G.K. Investments, like Aurora, paid dividends on its shares and interest on its notes from the profit engendered by lending this money, and charged management fees to other borrowers from Atlantic Acceptance and its subsidiary companies for what, essentially, amounted to Morgan's intercession on their behalf. Its investment policies and operations generally were again, like those of Aurora, entirely under the direction of Morgan without any intervention by Gregory or King; Morgan, as King said, was regarded as a "financial wizard" after arranging the highly profitable acquisition of Atlantic's minority interest in Commodore Sales Acceptance. N.G.K. was used to finance Frederick's Department Store in London shortly after its incorporation, and used its $250,000 loan from Aurora to purchase Aurora's small, but moderately successful subsidiary, Mavety Film Delivery, for which, by the time both Aurora and N.G.K. became bankrupt, N.G.K. had paid less than $100,000. Since Aurora's main source of funds was Commodore Sales Acceptance, this transfer of Mavety from Aurora to another of Morgan's vehicles in fact diminished the assets against which Commodore Sales Acceptance had recourse.

The story of Commodore Business Machines has the same general theme with two major variations. Both Jack Tramiel and Manfred Kapp were what were known in the early post-war years as "displaced persons", Tramiel from Poland and Kapp from Germany. Their first association was in the United States Army which brought them to New York, where they set up in a modest way in the business of repairing and reconditioning typewriters in the early 1950s. Tramiel had family connections in Toronto, and persuaded Kapp to dispose of the New York business and join him there in a new enterprise called Everest Office Machine Company (Canada) Limited, to carry on the old business of marketing used typewriters supplied from New York; in 1958 they formed Commodore Portable Typewriter Company Limited to exploit the market for cheap portable typewriters made in Czechoslovakia. They had some success in placing these with Eaton's and Simpson's, the two leading Toronto department stores, in due course found their bank credit inadequate and applied to Annett & Co., Toronto investment dealers, for financing. Carman G. King, a partner in that firm, led them to Morgan, who found their company exactly suited to his plans for a factoring subsidiary and took the financing of the typewriter enterprise into his own hands.

This involved, as might be expected, a large interest for him, and both Tramiel and Kapp contended that he was in effect the real owner of their company. There followed for Commodore Portable Typewriter a change of name to Commodore Business Machines (Canada) Limited, the establishment of a New York State subsidiary company in 1960 in association with one George Purvin, and in 1962 a public issue of shares and the listing of the company's securities on the Canadian Stock Exchange in Montreal. By a settlement of outstanding obligations with Purvin at the expense of the company, Morgan, Tramiel and Kapp acquired his 25% interest in Commodore Portable Typewriter at a cost of one dollar.

The major variations referred to amounted to this: Morgan's participation in the affairs and, indeed, the substance of Commodore Business Machines presented him with the opportunity, first, of manipulating the market for its shares and, second, doing the same with those of Analogue Controls Inc. after Commodore Business Machines sold its controlling interest in that company. Prior to the public issue Morgan, Tramiel and Kapp had amassed three-fifths of all the shares of Commodore Business Machines at prices ranging from ⅕ of a cent to 72½ cents a share, and Morgan used two Trio companies, Dallas Holdings and Valley Farm and Enterprises, to corner 87% of the 300,000 shares available for public distribution at a price of \$2.30 per share; Aurora Leasing lent the three men and the two companies upwards of \$700,000 to do so, and obtained the money by borrowing it from Commodore Sales Acceptance. The public issue was underwritten by another Toronto stock-broking firm, Barrett, Goodfellow & Co., who now became Morgan's favourite brokers, and the offering was made at \$2.50 per share; the proceeds of the underwriting went to Commodore Sales Acceptance to pay off Commodore Business Machines loans from that company, and to reduce its borrowings from the Atlantic group which had reached a figure of some \$1,400,000. No actual reduction in the indebtedness to Atlantic occurred, since the loans by Commodore Sales Acceptance to Aurora Leasing, with which the Trio and Morgan, Tramiel and Kapp, under the name "Don Mills", had financed purchases of stock, had correspondingly increased. This device of creating the illusion of repayment by merely transferring the debt to other hands was to become a trademark of Morgan's lending operations.

Since the Canadian Stock Exchange required evidence of public distribution before listing for trading the shares of an applicant for that facility, and, under the easy-going rules prevailing on that exchange in 1962, had laid it down that at least 20% of the issued and outstanding shares were to be held by the public, exclusive of officers, directors, promoters or their agents and trustees, with at least 100 shareholders each

holding one board lot or more, something had to be done by the promoters in this case to transform the sixteen actual shareholders, immediately prior to the public issue, into a satisfactory number. Here again the process was simple for the rapacious and unprincipled manipulator. Lists of dummy shareholders, consisting of names of friends, employees and relatives, were constructed, and share certificates issued in their names with powers of attorney for transfer endorsed in blank. In some cases the designated recipients actually signed their own names to the powers of attorney, as in that of the list procured by John R. Shemilt,[1] office manager of Netherlands Overseas Corporation Canada Limited, whom the Trio had assisted to acquire John Belli Operations and who had successfully masked C. P. Morgan's acquisition and sale of his share of the minority interest in Commodore Sales Acceptance. In other cases the signatures were simply written in by Walton and his employees, and in almost every case the persons who witnessed and guaranteed the signatures had never seen them written or acknowledged; Shemilt, for instance, never subscribed his name as witness to any of the signatures which he had actually seen affixed. In this transaction two young Toronto solicitors, Carl M. Solomon and Irwin Singer, practising at the time under the firm name of Solomon, Singer & Rosen, played a regrettable and unprofessional part. Singer admitted, in his examination under oath, to having witnessed and guaranteed signatures which he had not seen written, purporting to belong to people he did not know and which, in at least one case, he knew to be false. He then wrote a letter, on July 26, 1962, to the Canadian Stock Exchange, enclosing a listing statement and asserting that there were 295 shareholders of the 816,000 outstanding shares for which listing was sought, and that 64.75% of these shares were in the hands of the public. Of the complicity of Solomon, the senior partner of this firm which represented Commodore Business Machines in the deception thus practised on the Canadian Stock Exchange, there can unfortunately be little doubt, and none at all in relation to that of Morgan, Walton, Wagman, Shemilt and Rennie A. Goodfellow, a partner in Barrett, Goodfellow & Co. It is not reassuring to learn from the evidence surrounding the transaction that this type of deception has been practised before. If it had not been for the chance discovery of sales confirmation slips of the Barrett, Goodfellow firm that were returned in the mail, with written comments indicating that the recipients knew nothing about the purchases apparently made, this aspect of the promotion of Commodore Business Machines might not have been discovered by the Commission's investigators.

Carefully traded in a thin market, the shares of Commodore Business Machines by January 1963 reached a price of $4.45 a share. Out

[1]The purported signature of Shemilt's wife must be considered an exception. See Chapter VIII, p. 339.

of 464,400 escrowed shares Morgan, Tramiel and Kapp and members of their families held 315,000 which, by the beginning of July, were all released from escrow. The vehicle employed to hold these shares, and thus control the market, was Associated Canadian Holdings Limited, the shares of which were issued to them in exchange for their shares of Commodore Business Machines at a price of $3.50 each. By the end of July 1963 Associated Canadian Holdings owned 400,000 of the 816,000 issued shares of Commodore Business Machines, having acquired the additional amount from Dallas Holdings, Valley Farm and Harry Wagman. Thereafter the "insiders", including the Trio companies, traded briskly, and 90,000 of the shares held by Associated Canadian Holdings were disposed of in Germany through Harold Antin and the Bank Maerklin in Frankfurt. Public interest was not, however, sufficiently evident, and nearly all of these shares were sold back on the Canadian Stock Exchange to the supporters of the market. In October 1964, probably at the suggestion of Allen Manus, the promoter of the Lucayan Beach Hotel, Morgan made the desperate decision to place his fortunes in the hands of Frank Kaftel, a notoriously fraudulent stock promoter with established connections in the world of organized crime. Kaftel was visited by Morgan, Goodfellow and Tramiel in Paris, and for a substantial share of the trading profits undertook to promote the stock of Commodore Business Machines in his International Financial Advisory Service, a tout sheet published in Luxembourg. Commodore Business Machines stock, under this pressure, reached a high of $10.50 in 1965, before the collapse of Atlantic sent it downwards to a low of $1.10 per share, and although almost all the cash profits of Morgan's trading, amounting to $372,000, went to Kaftel as commission, Morgan held some 81,000 shares just before the collapse, of which over 11,000 were free in the hands of himself and his wife.

Morgan's coup in the shares of Analogue Controls was more lucrative, although there again he resorted to Kaftel and had to split the profits with him. Commodore Business Machines had acquired 202,000 shares of Analogue in 1962, and a further 130,000 in 1963, which gave it a majority interest in the shares of this American company manufacturing potentiometers, originally a stock promotion of Annett & Co. with shares listed on the Toronto Stock Exchange. These purchases were financed by Aurora Leasing Corporation and the Franklin National Bank of Franklin Square, Long Island, N.Y. Then in 1964, and after the financial statement of Analogue Controls, a notably unprofitable company, had been made presentable by false and misleading entries, the shares were sold to a company called Mortgage Trust & Savings Corporation (Bahamas) Limited, incorporated in the Bahama Islands and wholly owned by C. P. Morgan. The sale at $1.45 per share yielded a small profit to Commodore Business Machines, and the purchase by

Mortgage Trust & Savings was financed by selling 75,000 shares to Manhattan Sound Corporation, a New York company in which Morgan and his wife held between them a quarter interest, and which borrowed the money to pay for them from Commodore Factors, pledging the stock as security. As a result Mortgage Trust & Savings was left with 275,000 shares at a net cost of 72¢ per share. Using Barrett, Goodfellow & Co. in Toronto, and an account in the name of "Morgan Trust" at the Royal Bank of Canada branch in Freeport, Grand Bahama, Morgan managed a delicate market operation in which numerous brokerage accounts, including one, at least, operated by the notorious Myer Rush, drove the price of Analogue shares on the Toronto Stock Exchange to $7 per share before trading was suspended on May 13, 1965. By this time he had disposed of all but 22,000 shares which were free in his hands, had made a cash profit of slightly more than $370,000 and had acquired shares of another Bahamian company called Cimcony Limited, with a par value of $300,000, from an associate by the name of George H. Weinrott whose activities are mentioned in various places in this report.

Commodore Business Machines was not a profitable operation in those early years when it was attracting large loans of Atlantic money. Although it reported a profit at January 31, 1960 of some $4,000, this was due to a negligible allowance for depreciation on its tools and dies, and losses were reported for the following year and the five months ended June 30, 1961. When its shares were listed on the Canadian Stock Exchange a different story was told by its published financial statements, which were thereafter consolidated with those of Canadian and American subsidiary companies, and it relied heavily on non-recurring items of sales to produce profits for 1963 and 1964. The position at June 30, 1965 was a real disaster and exposed a net loss of well over $1,000,000; since Tramiel had sent a letter to the shareholders on March 5, 1965, commenting enthusiastically on the semi-annual position at December 31, 1964, they must have been severely shocked when they finally received the report for June 30 which did not appear for nearly seven months after that date. There is no doubt, however, that Tramiel's interim report helped sustain the market in Commodore Business Machines shares while the Kaftel operation was in progress. In addition to issuing common shares the company made one public and two private placements of convertible debentures, and a private placement of subordinated notes and preference shares with a face value of $2,000,000, of which $1,500,000 was taken up by British Mortgage & Trust Company. In all, Commodore Business Machines secured $5,021,000 by these means, of which British Mortgage & Trust Company provided $2,525,000 and Aurora Leasing Corporation $1,192,000. The balance of the issue of subordinated notes and preference shares was subscribed for by a company called Trans Commercial Acceptance, with money typically lent to it by

Commodore Business Machines. This company was incorporated in 1963 by Tramiel and Kapp to assume a debt of almost $1,000,000 owing by Commodore Business Machines to Commodore Sales Acceptance, and to pay, incidentally, 3½% less interest on that debt than it received from Commodore Business Machines thereafter; a companion company, Baronet Associates Inc., was later incorporated in the United States to intervene in similar fashion between Commodore Factors and the American subsidiaries of Commodore Business Machines. This neat device had the effect of virtually eliminating the indebtedness of that company to the Atlantic subsidiaries, and transferring it to two corporations with only nominal capital and no assets; their Commodore Business Machines receivables continued to grow as Atlantic money was advanced to them, while the interest "spread" accrued to Tramiel and Kapp. Then, in September 1964, Associated Canadian Holdings subscribed $115,000 for shares of Trans Commercial Acceptance of which $90,000 was, in the course of a very complicated transaction, obtained from Commodore Sales Acceptance and Aurora Leasing Corporation; these shares were subsequently resold to the Canadian subsidiary of Hugo Oppenheim und Sohn, a German bank controlled by Tramiel, for $250,000, a sum also provided indirectly by Atlantic Acceptance. If it had not been for the purchase in 1963 by Commodore Business Machines of the Willy Feiler concern in West Germany, a successful manufacturer of portable adding machines, for $1,000,000, and its sale after the Atlantic collapse to Litton Industries of the United States for over $3,000,000, Commodore Business Machines would have been bankrupt in 1965, instead of providing renewed excitement for stock-market speculators in recent months.

The Hugo Oppenheim Bank touches the affairs of Atlantic Acceptance at several points, and its story illustrates both the ingenuity of Morgan and the resourcefulness of Tramiel. The idea of buying control of a private bank probably occurred to Tramiel in the first instance, because he was familiar with the part they played in the German economy—they are investment dealers with deposit-taking privileges and have no exact counterpart in our own—and he had lived in Germany, spoke the language, and acquired the Willy Feiler Company for Commodore Business Machines. As in everything, however, it was necessary to look to Morgan for the necessary funds. Morgan conceived of a daring scheme, simple in outline, complicated in execution and thoroughly dishonest in purpose. Atlantic Acceptance would advance the money to buy control of the Bank and infuse new capital into it; the Bank would buy Atlantic treasury shares, thus compelling Great Northern Capital Corporation to match the purchase by one of its own to maintain its position as majority shareholders, and in consequence enhance Atlantic's capacity to borrow in the money market under the

terms of the deeds of trust. Two considerations were paramount; along the way the real nature of the transaction must be concealed to prevent discovery of the fact that Atlantic was unlawfully buying its own shares, and Morgan must also profit from it personally and, of course, secretly. What happened has been dealt with at length in Chapter X. Suffice it to say here that George H. Weinrott's Bahamian company, Cimcony Limited, was used to make an offer to purchase 120,000 shares and $3,000,000 of subordinated notes payable in U.S. funds in September of 1964, on behalf of a syndicate the identity of which was not disclosed; Great Northern Capital was persuaded to find $2,000,000 in U.S. funds for the purpose of buying an additional 120,000 shares for its own portfolio; and Atlantic advanced $2,750,000 in Canadian funds to Commodore Sales Acceptance, which lent it forthwith to Aurora Leasing Corporation, which, in turn, advanced a total of $2,254,200 in Canadian funds to Jack Tramiel to buy 80% of the recently increased capital stock of the Hugo Oppenheim Bank, recording this advance as a loan, without security or even the evidence of a promissory note, to Evermac Office Equipment Company which the old Everest company had now become. The German bank, induced by Tramiel to use this money for an investment in 120,000 common shares of Atlantic Acceptance, was then revealed by its cabled offer as the prospective purchaser to the Atlantic directors. Tramiel, duly elected chairman of the Bank's board, persuaded its management to enter into two agreements with Cimcony Limited, providing for the sale of 38,500 of its Atlantic shares to Cimcony for some $700,000 in Canadian funds, and giving Cimcony what amounted to an option to purchase the remaining shares on or before April 23, 1966 for $1,475,000, for which in the meantime it would pay the Bank monthly "option payments", amounting roughly to 7½% per annum, on this sum. Morgan's Bahamian company, Mortgage Trust & Savings, had acquired a 25% interest in Cimcony in exchange for 75,000 of its Analogue shares and Cimcony, of which he was thus a part owner, borrowed $500,000 in U.S. funds from Aurora Leasing with which to pay most of the purchase price of 38,500 shares of Atlantic to the Hugo Oppenheim Bank. As in any condensation of a complicated transaction, there is some danger of over-simplification here, particularly since the tenor of the agreements between the Bank and Cimcony is in dispute, but such was the gist of it. The complete fulfilment of this carefully contrived plan was, of course, frustrated by the collapse of Atlantic. It had one immediate result which must be briefly referred to.

Under the trust deeds securing its senior and subordinated debt Atlantic Acceptance was permitted to issue senior notes up to 350% of its consolidated net worth plus the amount of its subordinated debt, and subordinated notes up to 150% of its consolidated net worth. "Consolidated net worth" was defined in such a way as to correspond generally

with shareholders' equity, less certain prescribed deductions; in consequence, if all the permitted borrowing under these ratios had been undertaken as a result of issuing 240,000 common shares for $4,000,000 in U.S. funds, fresh money amounting to $43,000,000 would have been available, after allowing for the fact that $2,000,000 merely went round in a circle and was not fresh money at all. It has been seen in Chapter XVI that, if the company had calculated its senior debt correctly in accordance with the provisions of the trust deed, and honestly reported its financial position to the trustee as required for August 31 and September 30, 1964, it would have revealed that senior debt exceeded the limitation of 350% by over $2,500,000 and $9,000,000 at those dates respectively. Since these events of default were successfully concealed and, by December 31, the company was able to report correctly that senior debt outstanding was within the limitation, the importance of this manoeuvre can be accurately assessed.

The management and the other directors of the Hugo Oppenheim Bank were systematically misled by Tramiel in most of the transactions in Canadian securities which they undertook under his direction. To be sure, he told them that Atlantic Acceptance Corporation was the "house bank" for Commodore Business Machines which was true enough, but he represented to them that he was at all times acting on his own behalf, and did not reveal the position of Evermac Office Equipment as the borrower from Atlantic of the funds necessary to purchase his commanding interest in the Bank's shares, or the fact that he was that company's nominee, which he later asserted in an affidavit given to its trustee in bankruptcy. The Bank was used not only to buy Atlantic shares but those of Commodore Business Machines, and, as a result of its transactions in both, it was able to show a profit at the end of 1964 which restored a previous impairment of its capital in the amount of some D.M. 800,000; this profit, however, was used to buy for its Canadian subsidiary, Hugo Oppenheimbank (Canada) Limited, all the shares of Trans Commercial Acceptance from Associated Canadian Holdings. The deputy chairman of the Bank, Baron von Rheden, and its general manager, Wolfgang Wirth, informed the Commission that they had agreed with Tramiel to establish a finance company in Canada, and that this was the rôle designed for the subsidiary until Tramiel foisted his own vehicle upon them. However by an incredible piece of folly, considering the independence granted by German banking law to the management as opposed to the directors of a German bank, Wirth provided Tramiel with two blank cheques and an authorization to manage the Bank's investments in North America. As a result Hugo Oppenheim und Sohn found itself the owner of 1,250,000 shares of Lucayan Beach Hotel and Development Limited, for which it had borrowed $3,780,000 in Canadian funds from Commodore Sales Acceptance and paid it into an

account opened by Tramiel at British Mortgage & Trust Company, an arrangement designed to reduce the indebtedness of Dalite Corporation (Canada) Limited which owed very large sums to Commodore Sales Acceptance; this had the familiar effect of transferring that indebtedness to a new debtor rather than repaying the lender.

At this point, in April 1965, Tramiel was helping Morgan to extricate himself from a situation, described at considerable length in Chapter IX, in which upwards of $10,000,000 of Atlantic funds had been immobilized in financing the construction of portions of the Lucayan Beach Hotel complex on Grand Bahama Island, and in making advances to the hotel company for the benefit of its president and promoter, Allen S. Manus, a former Toronto stock salesman who had prospered in New York with his brother Cecil. Manus had acquired the hotel on precarious terms from the Grand Bahama Development Company Limited, a company formed by Louis A. Chesler in association with Wallace H. Groves to exploit the latter's baronial rights to a large portion of that once desolate island. The only hope for both Morgan and Manus was to arrange financing on a large scale for the hotel company, and the purchase of shares by the Hugo Oppenheim Bank, made according to its management without their knowledge, had the effect of conferring upon the 10,000,000 ordinary shares of Lucayan Beach Hotel and Development a fictitious value of £1 each. A short and simplified account of the Atlantic commitment in the Bahamas must here be attempted.

Dalite Corporation received its first loans from Commodore Sales Acceptance in 1961, and for ten years previously, under the management of its president, Eugene Last, it had carried on the business of making furniture and structural panelling. The reason for approaching Morgan was Last's inability to obtain bank credit for developing prefabricated housing such as was required at the time by the Department of Northern Affairs. By the end of 1961 Atlantic loans amounted to almost $350,000, but in the spring of the following year, in order to secure substantial new advances, Commodore Sales Acceptance took in pledge 75% of the company's stock and the written resignations of its directors, to be lodged with a trust company as security for payment of two debentures with a combined face value of $1,000,000. At the same time Last made over to C. P. Morgan personally the remaining 25% of Dalite stock, which was held for Morgan until May of 1965 by Carl Solomon as trustee, when it was handed back in an attempt at a final settlement of the Dalite position. By the end of 1964 these loans exceeded $7,000,000, the debentures were in default, no claim was ever made on the trust company for the delivery of Dalite stock or the resignations of its directors, and the security of Commodore Sales Acceptance

consisted effectively of an assignment of book debts which, at their face value, could have realized only a fraction of the money lent. At December 31, 1962, and for financing prefabricated housing supplied by Dalite for erection at Thompson, Manitoba, over $1,600,000 of Atlantic money had been lent to Dalite with a greatly diminished prospect of recovery, and to repair this situation Morgan had called in George H. Weinrott and embarked on loans to Cimcony of Canada Limited, which in the end cost Atlantic well over another $1,000,000. It must therefore have been with some relief, and with a view to making an enterprise in which he had a substantial concealed interest eventually profitable, that Morgan seized the opportunity in the spring of 1963 of securing for Last's company a contract to supply prefabricated housing under ideal climatic conditions for the employees of Lucayan Beach Hotel, due to open at the end of that year. A Bahamian company called Daylite of Grand Bahama Limited, originally planned, according to Last, to be owned equally by Morgan and Manus, and shares of which were eventually equally divided between Dalite Corporation and Associated Canadian Holdings, was formed to do the work, and Atlantic money was advanced to it by loans made to Dalite Corporation which made advances in its turn to the new company at Freeport. This device, which put the Trio and Tramiel and Kapp in the way of further personal profit, was no doubt imposed on Morgan by the terms of the Atlantic trust deeds confining "finance business" to Canada and the continental United States. Yet another company, Masco Construction Company Limited, in which Morgan, and apparently Manus and Wagman, had an interest and which had originally been formed to supply Dalite products to Daylite of Grand Bahama at a mark-up of 5%, was used, when this plan proved to be unworkable, to supply funds to the Bahamian company. At the same time, Manus' blandishments, and the necessity of preserving his commitments to Grand Bahama Development Company, required fresh infusions of Atlantic money, even to the extent of paying the operating costs of the hotel after it opened. Manus was thoroughly incompetent as an administrator, but he was a shrewd and faithless associate, as Morgan found to his cost and that of Atlantic Acceptance when he sought to secure its position for the large loans that had been made. His attempt to displace Manus by having the hotel, and the ancillary buildings constructed by Daylite of Grand Bahama, leased to a company controlled by himself and incorporated in February 1965 as L.B.H. Management Limited, barely succeeded because of Manus' dependence on him for further loans; yet Manus continued to live in the hotel on the most lavish scale and to bedevil all the efforts of Morgan's agents to put its affairs in order. In the end the state of the advances of Atlantic money, the security obtained and the recovery as estimated by the

receiver and manager in August 1966, appear in the review of loans filed in the Supreme Court of Ontario as follows:

| | *Amount of Loan* | *Estimated Recovery* |
|---|---|---|
| Direct loan to Dalite Corporation (Canada) Limited against which the security held is a registered general assignment of Dalite Corporation (Canada) Limited receivables which includes advances by that Company to Daylite of Grand Bahama Limited of .... | $ 3,850,000 | |
| Direct loan to Masco Construction Company Limited of .............................. | 785,000 | $ 850,000 |
| Security held includes notes of Daylite of Grand Bahama Limited in the face amount of $990,000 given as security by Daylite of Grand Bahama Limited to Masco Construction Company Limited for cash loans to Daylite of Grand Bahama Limited | | |
| Direct unsecured loan to L.B.H. Management Company Limited of ........ | 500,000 | 25,000 |
| Investment in shares of Lucayan Beach Hotel and Development Limited: | | |
| Direct investment through Oppenheim Bank to purchase 1,250,000 shares of Lucayan Beach Hotel and Development Limited .............................. | 3,750,000 | |
| Shares acquired as security for a loan of $1,250,000 made by Aurora Leasing Corporation Limited to Freeport International Limited—1,250,000 shares .................................................... | 1,250,000 | 4,300,000 |
| | $10,135,000 | |
| Sundry other shares acquired in loan transactions—550,000 shares ................ | | $5,175,000 |

To the amount of loans shown above must be added approximately $1,190,000 invested or advanced by Associated Canadian Holdings, Masco Construction Company, Dallas Holdings and Aurora Leasing Corporation, and consisting of funds indirectly proceeding from Atlantic Acceptance as described in Chapter IX. After this huge expenditure

had been made Atlantic's real security consisted only of some 3,050,000 shares of Lucayan Beach Hotel and Development, as compared with approximately 4,000,000 in the hands of the Manus brothers and their companies, out of a total of 10,000,000 outstanding. Morgan was undoubtedly obsessed with the situation and amenities of the Lucayan Beach Hotel, but, while constantly looking after his own personal interest, neglected that of the Atlantic companies, leaving them with completely inadequate security and none of it liquid. Neither in Eugene Last nor Allen Manus was he dealing with honest men, and the evidence before the Commission shows that he either knew, or had the means of knowledge of their quality from the beginning of his association with them.

I have made an attempt to condense into a few pages the events of seven years of intense activity on the part of C. P. Morgan, more elaborately treated elsewhere in this report, to demonstrate the part played by his unfettered control over the affairs of Atlantic Acceptance Corporation. The word "unfettered" is no mere figure of speech because, throughout the period during which the company was supported by the Lambert partners, no attempt was made to establish a committee of the board of directors to pass upon the advisability and limits of any of the loans made amounting to many millions of dollars, and only a perfunctory effort at the end of the period was begun to organize an internal committee of senior employees at Oakville to pass upon loans made in the course of the more conventional sales finance business carried on there. The complacency of Morgan's fellow directors arose principally from their unbounded confidence in his ability and was nourished by the gratifying results which he reported from year to year, achieved as they were by questionable accounting devices, gross understatement of the accounts receivable in the Adelaide Street group of subsidiary companies, and, whenever it suited his purpose, breaches in the covenants of the trust indentures which were not only never reported to the trustee but were carefully concealed. Had these devices and shortcomings not been resorted to, or, having been resorted to, exposed, the Atlantic group of companies taken as a whole would have been shown to be insolvent and consequently in default, certainly in 1964 and probably in 1963. The loss engendered by the issue of 240,000 new common shares in the autumn of 1964 fell upon the shareholders and noteholders, the former by the dilution of their equity and the latter by creation of the illusion that the purchase by the Hugo Oppenheim Bank represented new money upon which the debt structure could be maintained and enlarged. The enlargement indeed was substantial; at September 30, 1964 the debt secured under deeds of trust amounted to $89,610,000 of senior notes, $13,347,000 of subordinated and $3,350,000 of junior subordinated notes; at June 17, 1965 the approximate figures were $106,860,000, $16,800,000 and $4,350,000 respectively. When default occurred on

June 14 Morgan was in New York, on the point of raising an additional $10,000,000 of senior secured long-term debt in spite of the stringency created by President Johnson's "guide-lines", and it would be idle to contend that any one, even Morgan himself, had any real premonitions of disaster. After receivership had been ordered Jack Tramiel coolly confronted his fellow-directors of the Hugo Oppenheim Bank and representatives of the central banking authority in Berlin, and arranged the exchange of Evermac's interest in the Bank's shares for its Canadian assets in an agreement dated July 1, 1965, in which he again represented that he was acting on his own behalf. Among these assets were the Bank's remaining shares of Atlantic Acceptance, 75,000 of which Tramiel had already pledged with Traders' Realty Corporation in the purchase for Commodore Business Machines of a well-known purveyor of office supplies called Willson Stationers & Envelopes Limited, which he and Kapp had now to dispose of quickly, and which they succeeded in doing with the assistance of one Irving Gould, who replaced C. P. Morgan as chairman of the board of Commodore Business Machines and became its source of future financial support. Thus Commodore Business Machines, which had lived throughout on repeated transfusions of the life-blood of Atlantic Acceptance, barely escaped, with diminished resources, submersion in the welter of the finance company's fall. Morgan himself was neither as shrewd nor as fortunate as the men he had raised to riches. His own fortune, amassed without scruple and in defiance of all the accepted principles of honest business practice, was represented on the day of the Atlantic default by a net worth of $2,000,000; a fortnight later the actions of those banks and brokers with whom his securities were pledged, and of the markets upon which they were thrown, reduced it to a few thousands. He had only sixteen months to live, and to observe investigators from many agencies raking the ashes of his enterprises for the evidence which would, in all its massive incrimination, have sent him to prison for many of the years remaining to him in the course of a normal expectancy of life.

* * *

**Compensation for Loss Through Fraud**

The failure of a finance company may not be as damaging to public confidence as that of a bank or a trust company, since deposits and guaranteed investments are not at stake, but, because of borrowings in the money market when its obligations are described as "secured", the shock to the investing public may be little less severe. For this reason it has been suggested in some quarters that finance companies should be weaned away from borrowing under the security of deeds of trust, and should raise their money in the market as many do in the United States simply on the strength of the covenant of the borrower to repay, with

provision of a prospectus and such periodic information as borrowers may require. The argument is, to some extent, based on the belief that the security usually afforded by a trust deed is misleading because of the many saving clauses protecting the trustee from liability. It is evidently for this reason that the Business Corporations Act 1968, still at the time of writing under consideration after introduction as a bill in the Legislative Assembly of Ontario and given first reading only, contains in sections 57 to 61 inclusive provisions making the duties of what is described as "an indenture trustee" more onerous, and confining within narrow limits the grounds on which such a trustee may be relieved from liability. It is pertinent to observe that provisions of similar stringency contained in the United States Trust Indenture Act of 1939 are regarded as responsible for the flight from borrowing secured by trust deeds in that country. It would seem that if the regulatory authorities want these provisions to be effective for finance companies borrowing in the money market they will have to make this procedure mandatory, either by legislative enactment or the requirements of the Ontario Securities Commission. The consequences of a decision in these terms are not easy to foresee, but it is probable that finance companies under compulsion of this kind would be at a disadvantage in competition with those which were not, and did not have to pay the substantially higher fees which a trustee would be entitled to demand if the proposed sections are eventually enacted. Interference with freedom of contract is not to be lightly undertaken, even to protect the public from loss, and since it is generally accepted that the development of a Canadian money market is of the first importance, if only to relieve Canadian businessmen of their traditional dependence upon foreign sources of funds, flexibility in the conditions of borrowing should be preserved. The Securities Commission, it may be noted, has the power to prescribe the conditions under which finance company obligations must be secured, as witness the following provision of the Securities Act 1966:[1]

> 61-(1) The Director [*i.e. of the Ontario Securities Commission*] may in his discretion direct the Registrar to issue a receipt for any prospectus filed under this Part, unless it appears to the Director that, . . . .
>
> *(f)* in the case of a prospectus filed by a finance company,
>
> (i) the plan of distribution of the securities offered is not acceptable to the Director,
>
> (ii) the securities offered are not secured in such manner, on such terms and by such means as are required by the regulations, . . . .

The failure of the Prudential Finance Corporation in 1966, still under investigation by the Ontario Securities Commission, provides a

[1]S.O. 1966 c. 142 as amended by 1967 c. 92.

good example of the real difficulty. This was a small sales finance company which began and for many years carried on business in London, Ontario after 1928. In 1961 its main offices were moved to Toronto and its business was transformed under the direction of a new president by the name of J. B. Brien. Thereafter it began to accumulate subsidiary companies, not in the finance business which the parent company largely abandoned, and its reported assets rose from about $1,600,000 in that year to over $25,000,000 at the time of its bankruptcy, with an estimated realizable value of $6,700,000. Without attempting to anticipate the conclusions of the current investigation it may be said, as is well known, that the loss to small investors was particularly severe and greater in proportion to the whole than in the case of Atlantic Acceptance. The holders of Prudential obligations, which yielded an unusually high rate of interest sufficient to proclaim the risk attendant upon purchasing them, have sought full compensation from the Province of Ontario for the unusual reason that their losses were due to the fraudulent conduct of the company's president and its auditor, and that they were entitled to rely on the Securities Commission for protection which was not forthcoming. Since the securities concerned were sold under "high pressure" and their yield was in excess of what a prudent investor might expect to receive at the time, it is permissible to doubt the advisability of employing public funds for such a purpose. Although the operations of Prudential were on a much smaller scale than those of Atlantic, their failures have one feature in common; the presidents of both of them used their unchallenged authority dishonestly and in their own interests, which were in conflict with those of their companies and those investors and lenders who had confidence in them.

The Commission has made inquiries as to legislation existing, and proposals under consideration, in other jurisdictions for providing out of public funds compensation to those who have suffered loss through fraud. After long and anxious consideration I have concluded that the only proper basis for this would be the committing of a wrongful act, or the failure to perform a duty by a servant of the Crown, constituting the proximate cause of such loss being suffered in a case where the Crown or one of its agencies assumes responsibility for supervising and regulating transactions in the course of which fraud has taken place. The Proceedings Against the Crown Act 1962-63,[2] appears to provide a remedy under subsection 3 of section 5.

> (3) Where a function is conferred or imposed upon a servant of the Crown as such, either by a rule of the common law or by or under a statute, and that servant commits a tort in the course of performing or purporting to perform that function, the liability of the Crown in respect of the tort shall be such as it would have been if that function had been conferred or imposed by instructions lawfully given by the Crown.

[2]S.O. 1962-63 c. 109.

The remedy is nevertheless much circumscribed by the next subsection.

> (4) In proceedings against the Crown under this section, an enactment that negatives or limits the liability of a servant of the Crown in respect of a tort committed by that servant applies in relation to the Crown as it would have applied in relation to that servant if the proceedings against the Crown had been proceedings against that servant.

In the case of the Ontario Securities Commission, for instance, established to regulate the issuing of securities in the interest of the public and for its protection, subsection 1 of section 142 of the Securities Act provides:

> 142.—(1) Except with the consent of the Minister, no action whatever and no proceedings by way of injunction, mandamus, prohibition or other extraordinary remedy lies or shall be instituted,
>
> *(a)* against any person, whether in his public or private capacity, or against any company in respect of any act or omission in connection with the administration or the carrying out of the provisions of this Act or the regulations where such person is a member of the Commission, a representative of the Commission or the Director or Registrar, or where such person or company was proceeding under the written or oral direction or consent of any one of them or under an order of the Minister made under this Act; . . .

Whether or not this section is "an enactment that negatives or limits the liability of the servant of the Crown" may be a matter for judicial interpretation, but it would appear to be so. If it is, then the question as to whether holders of securities can look to public funds for compensation where loss has been suffered by reason of a fraud, successful only because of the tortious act or neglect of a servant of the Crown whose duty it was to prevent it, is within the discretion of a minister of the Crown to decide. In other words the decision is political, and a claim for compensation could not apparently be entertained by the courts unless permission to sue were first granted by the executive. Since without this type of protection it would be difficult for public authorities to function, even if they could recruit the necessary personnel, it would not appear to be practicable to seek compensation from the public treasury under existing legislation as a matter of right. I have not thought it necessary or desirable to recommend legislative change which would result in the automatic compensation of the imprudent investor at the expense of the general taxpayer.

**The Loan Committee**

The lending activities of C. P. Morgan in the field of commercial loans, which were particularly destructive in the case of Atlantic Acceptance, could not have been undertaken if a loan committee had been

constituted by the board of directors. Although some of the members of the board must be severely criticized for the part they played in some transactions, and others to a lesser extent because they played no part in any, it is not suggested that they would have supported the president of the company in most of the situations which have been described in this report, unless information to which they were entitled had been successfully withheld or falsified. It may well be that there are now no finance companies in Canada which do not have such a committee, or where loans above a certain limit or of a certain character are not submitted to the entire board. Nevertheless some legislative provision should be made to ensure, at least, the review of commercial, factoring and wholesale loans above prescribed limits. In the case of Atlantic, commercial lending was largely done by the Adelaide Street subsidiary companies with the affairs of which the directors of the parent company, even when directors of those subsidiaries, did not concern themselves at all. Even if loan committees are set up by directors of the subsidiary companies, those of the parent company must take the ultimate responsibility for loans made in excess of prescribed limits or of an unusual kind. Since loans made by the parent company to the subsidiaries themselves should also be scrutinized by directors of the former, it may be sufficient, where the directors of subsidiaries are also directors of the parent, to have one loan committee assume the responsibility for loans made by a group of companies where this is practical, and report at each regular meeting of the parent company's board. It is desirable, too, that the majority of the members of such a committee should be composed of directors who are not otherwise employees of the company. Except in the first two years of the company's existence, the directors of Atlantic met to consider chiefly the question of borrowing money and selling shares, and to enact the necessary measures to authorize this. The vital lending function of the company was entirely in the hands of management, and Morgan was accustomed to withholding information on this subject, or even giving false information when unduly pressed by his colleagues. It is obvious that the Canadian practice of electing directors with useful business connections, expected to play a mainly ornamental part without substantial remuneration, is a thing of the past, and will not survive the imposition of stricter liability upon them now contemplated in pending legislation. Directors of finance companies, in particular, must be intimately concerned with their company's lending policy and practice. Where, for convenience, it is necessary to delegate the responsibilities of the full board in this respect to a loan committee, this should consist of directors who are not associated with management, not "internal directors" as they are sometimes called, and this committee should report periodically to the full board. There are, of course, many aspects of finance company lending, particularly in the field of small loans and loans secured by conditional sales contracts and chattel mortgages, which

can be safely left to the discretion of the company's executive officers and their subordinates. The lesson to be learned from the failure of Atlantic Acceptance is that "commercial", or "industrial" loans, wholesale loans made to dealers, and loans made in the course of factoring accounts receivable must be fully understood and carefully scrutinized by a finance company's directors, whether made by the company itself or by any company subsidiary to it. Essential to this responsibility is the requirement that the directors as a whole, and in particular those who form the loan committee, fully understand and keep under review the provisions of any deeds of trust or agreements with lenders imposing limitations upon borrowing and conditions under which money may be lent. All of this demands directors of high calibre and experience to whom adequate remuneration must be paid, not derived from their employment in any other capacity by the company, except in the case of the presiding officers.

RECOMMENDATION VI

1. *The directors of a finance company should be required to authorize all loans made, or which are at any time outstanding, to any borrower, or any borrowers associated one with the other to the knowledge of the directors, in any amount exceeding 5% of the excess of its tangible assets over its liabilities determined quarterly, on a consolidated basis where appropriate (excluding inter-company loans), to keep under review the conditions of any agreement to which the company or any subsidiary is a party under which money has been lent to them, and to furnish shareholders of such companies, and the holders of any obligations issued by them, with certificates from each director, annexed to the financial statements laid before any meeting of the shareholders, that, in the course of the period to which such financial statements relate, they have obtained no knowledge of the breach of any condition of any such agreement which has not been otherwise disclosed to the parties thereto.*
2. *The directors of a finance company should be entitled to rely, for the determining of the excess of tangible assets over liabilities, on the accuracy of unaudited statements prepared from the books of the company, certified by its chief financial officer and its president, unless they have reason to doubt their accuracy.*

### Conflict of Interest in the Case of Directors

The law requiring disclosure of the interest of a company director has remained undisturbed since 1953 and may be found in the Corporations Act.[1]

[1]R.S.O. 1960 c. 71 s. 70.

70.—(1) Every director of a company who is in any way directly or indirectly interested in a proposed contract or a contract with the company shall declare his interest at a meeting of the directors of the company.

(2) In the case of a proposed contract, the declaration required by this section shall be made at the meeting of the directors at which the question of entering into the contract is first taken into consideration or, if the director is not at the date of that meeting interested in the proposed contract, at the next meeting of the directors held after he becomes so interested, and, in a case where the director becomes interested in a contract after it is made, the declaration shall be made at the first meeting of the directors held after he becomes so interested.

(3) For the purpose of this section, a general notice given to the directors of a company by a director to the effect that he is a shareholder of or otherwise interested in any other company, or is a member of a specified firm and is to be regarded as interested in any contract made with such other company or firm, shall be deemed to be a sufficient declaration of interest in relation to a contract so made, but no such notice is effective unless it is given at a meeting of the directors or the director takes reasonable steps to ensure that it is brought up and read at the next meeting of the directors after it is given.

(4) If a director has made a declaration of his interest in a proposed contract or contract in compliance with this section and has not voted in respect of the contract, he is not accountable to the company or to any of its shareholders or creditors for any profit realized from the contract, and the contract is not voidable by reason only of his holding that office or of the fiduciary relationship established thereby.

(5) Notwithstanding anything in this section, a director is not accountable to the company or to any of its shareholders or creditors for any profit realized from such contract and the contract is not by reason only of his interest therein voidable if it is confirmed by a majority of the votes cast at a general meeting of the shareholders duly called for that purpose and if his interest in the contract is declared in the notice calling the meeting.

(6) If a director is liable in respect of profit realized from any such contract and the contract is by reason only of his interest therein voidable, he is guilty of an offence and on summary conviction is liable to a fine of not more than $200.

Compliance with the provisions of this section has tended to be formalistic. In examining the minutes of meetings of directors in the course of this investigation the Commission has found, more often than not, only observations that "X declared his interest and refrained from voting". This, indeed, is the only record of the action taken by Alan T. Christie, Wilfrid P. Gregory and William H. Wallace at the meeting of Atlantic directors on April 27, 1961 when the purchase by the company of the minority interest in Commodore Sales Acceptance was authorized by

resolution, and J. Aubrey Medland, who refrained from voting for other reasons, was wrongly included with those described as "having declared their interest". Morgan, as previously observed, made no such declaration, since his undoubted interest had been fraudulently concealed. At the special general meeting of shareholders called to ratify this proposal on May 10 there was no recorded reference to this declaration of interest by directors, and it would appear that none is required by subsection 5 of section 70, although it is difficult to believe that the Legislature intended to deprive shareholders of the knowledge that a director might benefit from a contract which they are asked to ratify. Since minutes are generally and properly only a concise record of business transacted, it is not to be expected that, in the absence of statutory requirement, the nature of the interest declared will always be recorded.

The proposed Business Corporations Act 1968, by section 122, suggests important changes in what has hitherto been required:

> 122.—(1) Every director of a corporation who has, directly or indirectly, any interest in any contract or transaction to which the corporation is or is to be a party, other than a contract or transaction limited solely to his remuneration as a director, officer or employee, shall declare his interest in such contract or transaction at a meeting of the directors of the corporation and shall at that time disclose the nature and extent of such interest including, as to any contract or transaction involving the purchase and sale of assets by or to the corporation or a subsidiary thereof, the cost of the assets to the purchaser and the cost thereof to the seller if acquired by the seller within five years before the date of the contract or transaction, to the extent to which such information is within his knowledge or control.
>
> (2) Subsection 1 does not require the disclosure of any interest in any contract or transaction unless the interest and the contract or transaction are both material.
>
> (3) The declaration required by this section shall be made at the meeting of the directors at which the contract or transaction is first considered or, if the director is not at the date of the meeting interested in the contract or transaction, at the next meeting of the directors held after he becomes so interested, and, where the director becomes interested in a contract or transaction after it entered into, the declaration shall be made at the first meeting of the directors held after he becomes so interested.
>
> (4) If a director has made a declaration and disclosure of his interest in a contract or transaction in compliance with this section and has not voted in respect of the contract or transaction at the meeting of the directors of the corporation, the director, if he is acting honestly and in good faith, is not by reason only of his holding the office of director accountable to the corporation or to its shareholders for any profit or gain realized from the contract or transaction, and the contract or transaction, if it is in the best interests of the corporation, is not voidable by reason only of the director's interest therein.

(5) Nothwithstanding anything in this section, a director, if he is acting honestly and in good faith, is not accountable to the corporation or to its shareholders for any profit or gain realized from any such contract or transaction by reason only of his holding the office of director, and the contract or transaction, if it is in the best interests of the corporation, is not by reason only of the director's interest therein voidable.

*(a)* if the contract or transaction is confirmed or approved by at least two-thirds of the votes cast at a general meeting of the shareholders duly called for that purpose; and

*(b)* if the nature and extent of the director's interest in the contract or transaction are declared and disclosed in reasonable detail in the notice calling the meeting or in the information circular required by section 106. R.S.O. 1960, c. 71, s. 70, *amended.*

It will be noted that subsection 1 will, if this section is enacted into law, require disclosure of "the nature and extent of such interest", although its effect is somewhat vitiated by subsection 2 which fails to define "material", a failing which applies to other portions of the bill where such words as "reasonable" introduce uncertainty which should be avoided. Subsection 5 of section 122 is a notable improvement on subsection 5 of section 70 of the Corporations Act, since it provides that the general meeting of the shareholders must be informed of "the nature and extent of the director's interest in the contract or transaction". The addition of the word "transaction" to "contract" is also an improvement, and either word would evidently apply to a loan made by a finance company. It is suggested that an additional requirement should be imposed.

### RECOMMENDATION VII

*In addition to the provisions of section 122 of the proposed Business Corporations Act 1968, when a director of a finance company declares the nature and extent of his interest in any contract or transaction to which the company is or is to be a party, the minutes of any meeting at which such a declaration is made should record the nature and extent of the interest declared, and the correctness of the minute should be acknowledged by the signature of the director making the declaration.*

## The Need for Legislation

The task of recommending legislative changes, given to this Commission in its terms of reference, has been complicated by a number of circumstances. For one thing, the time consumed by examining the causes and effects of the failure of Atlantic Acceptance Corporation has been prolonged beyond the point originally contemplated, and I have not felt free to do the travelling abroad which is essential to a proper

study of comparative law and of proposals under examination in other jurisdictions. For another, the reconstituted Select Committee on Company Law has also been given the task of considering legislation applicable to finance companies and loan and trust corporations, and will no doubt be reporting almost contemporaneously with the presentation of this report. Since the Select Committee travelled widely in the course of preparing its interim report, it may be expected to do so again, and to provide the government of Ontario with useful information about problems and solutions occurring in other countries. Then again, the government has at its disposal the resources of the Ontario Law Reform Commission, a permanent body which has been active in producing reports as a basis for legislative change. Indeed the pressure which all this costly advice must bring to bear on any ministry to introduce legislation, in terms of recommendations of which a wealth are available, has dangers of its own; the community should be allowed to know from year to year what its rights and remedies are, and be able to make plans on the assumption that the law, although not cast in the mould popularly attributed to the Medes and Persians, enjoys some degree of stability under which plans for the future can be made. At the outset of this inquiry I made it clear that I did not expect amendments to statutes and criminal prosecutions to be suspended until after the appearance of my report, if the public interest urgently required that they should be undertaken. This view, which I believe to have been only common sense, has created difficulties for the Commission, not the least being the mere task of keeping up-to-date with what has been enacted since the autumn of 1965 and is under consideration in the future. Nevertheless, although the Loan and Trust Corporations Act has been amended at every intervening session of the Legislature, no legislation has been introduced affecting finance companies other than that of general application to all companies, with the exception of sections of the new Securities Act enacted in 1966[1] as amended by 1967 c.92 (Sections 61 and 62a) and the Public Finance Companies' Investments Act 1966,[2] an act proclaimed in force on January 1, 1967 of which the full title is self-explanatory: "An Act to Provide for the Registration of and Disclosure by Public Finance Companies that hold Shares in Private Loan Companies". The "Registrar", designated as the Registrar of Loan and Trust Corporations, was authorized to require information about the investments of public finance companies which were defined as follows:

> 1. . . . *(b)* "public finance company" means a company that has as one of its principal businesses lending or investing money, dealing in mortgages on the security of real or personal property or purchasing accounts receivable, or any combination thereof, and

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[1]S.O. 1966 c. 142.

[2]S.O. 1966 c. 124. At the time of writing a bill is before the Ontario Legislature to repeal this act.

that borrows or raises money from the public for any of such purposes, but does not include,

(i) a bank to which the *Bank Act* (Canada) applies,

(ii) an insurer licensed under *The Insurance Act,*

(iii) an issuer registered under *The Investment Contracts Act,*

(iv) a corporation registered under *The Loan and Trust Corporations Act,* or

(v) a credit union or credit union league incorporated under *The Credit Unions Act;*

My first thoughts on the subject of special legislation for finance companies were to the effect that none was required. Nevertheless the failure of Atlantic Acceptance and Prudential Finance in this province, of Alliance Credit Corporation in the Province of Quebec, of Commonwealth Acceptance Corporation in the Province of British Columbia and of the Pioneer and Mill Factors companies in the United States, with heavy attendant losses, have convinced me that finance companies have special characteristics and are subject to peculiar weaknesses, calling for carefully-drawn legislation to meet their own requirements and those of the public. I do not propose to make recommendations in detail as to what a Finance Companies Act, or a Public Finance Companies Act as the case may be, should contain, knowing from my own experience that drafting legislation is an art, and must be undertaken with an eye to the effect upon it of, and its effect upon many other statutes and the subordinate legislation incidental to them. I shall confine myself to making general recommendations as to the scope and scheme of a Finance Companies Act for Ontario. In the process I shall suggest the inclusion of the recommendations touching finance companies already made in this chapter which are set out in consolidated form at its end, and I would be wanting in both candour and consistency if I did not also suggest the exclusion of certain provisions of the bill known as the Business Corporations Act 1968 which have been adversely criticized in other chapters of this report. It seems clear that finance companies should not be created in the perfunctory way proposed for "business corporations", and, because of their special place and importance in the economy, should be founded either on the issue of letters patent or on a special act of the Legislature as provided for in the Small Loans Act of Canada; the latter process, perhaps considered archaic, involves both the executive and legislative branches of government and ensures the closest scrutiny consistent with what, in the context of other legislation, is widely known in North America as "public necessity and convenience". No change, however, of this magnitude should in any way preclude the continued existence of finance companies in being, or impeach their right to be licensed *ab initio* to carry on their customary business.

**A Finance Companies Act**

In the first place it should be said that no special emphasis need be put upon the use of the word "company" as opposed to "corporation". We still talk about "companies" and "company law", although the American fashion of preferring "corporation" and "corporation law" may be slowly winning its way, like other American fashions, into general use in Canada; indeed in Ontario the proposal to adopt the alien term "business corporation" from the law of the State of New York seems to justify, if only for the sake of simplicity, the return to the use of the well-understood word "company". In any event, it seems eminently desirable that two conditions should be observed for the creation of finance companies which depend so heavily upon the willingness of the public to lend and the ability of the public to borrow; their birth should be attended by a measure of public approval, and there should be relatively few of them in the interest of their own stability. Thus it would seem that the creation of finance companies in Ontario, or the licensing of finance companies created in other jurisdictions to carry on business in Ontario, should engage the full attention of the government of the province, and not be a matter of merely clerical scrutiny of a few signatures attached to a piece of paper, on the receipt of which a certificate of incorporation is expected to issue. In short, ability to carry on the business of a finance company should remain a matter of licence and not be considered a matter of right. At the same time the alienation and amalgamation of finance companies should receive careful attention from government authority, as in the case of loan and trust companies in Ontario. The annual reports of the Governor of the Bank of Canada make it plain that the position of finance companies in the money market, and as sources of credit across the country, is of similar, if not of equal importance to that of deposit-taking institutions. Finance companies should, like banks, insurance companies and loan and trust companies, also have their superintendent, inspector-general or registrar, whatever it may be considered convenient to call him, with direct access to a minister of the Crown, and he, assisted by a qualified and adequate staff, should be empowered to require information, make periodic inspections and publish reports on their affairs; the privilege of continuing in business should depend upon their conforming to certain standards set by him with government approval. This system has worked well so far in the case of insurance and loan and trust companies in Ontario, and should be extended to finance companies. Finally, the use of the terms "finance", "acceptance" and "loan" in the names of companies should be reserved for those companies to which they are appropriate, and not used to obscure the real function and direction of such a company as Prudential Finance Corporation turned out to be.

RECOMMENDATION VIII

1. *There should be an act to provide for the incorporation of finance companies in Ontario and the regulation of finance companies carrying on business in Ontario, within the limits of the jurisdiction of the Legislative Assembly of Ontario.*
2. *A finance company should be defined in terms similar to the definition of "public finance company" contained in section 1 of the Public Finance Companies' Investments Act 1966 S.O. 1966 c.124.*
3. *Notwithstanding the provisions of any other Act, a finance company should be incorporated by letters patent issued under the Great Seal.*
4. *The powers of a finance company should include those of making loans to the public and of borrowing from the public on the security of its debentures, bonds and promissory notes, subject to the provisions of the Securities Act.*
5. *There should be an Inspector-General of Finance Companies appointed by the Lieutenant Governor in Council on the recommendation of the appropriate minister of the Crown, under whom he should be responsible for the administration of the Act, inspection of the operation of finance companies from time to time and the obtaining and reporting upon such information as he deems necessary, or as may be required by the Act or any regulation made pursuant thereto.*
6. *No company should be permitted to carry on the business of a finance company in Ontario without a licence given by the Lieutenant Governor in Council upon the recommendation of the Inspector-General, terminable only after an inquiry by the Inspector-General and upon recommendation by him to the Lieutenant Governor in Council on such terms and conditions as the Lieutenant Governor in Council may see fit to impose.*

**Reports and Information to be Supplied to the Inspector-General**

Whatever reports may be required under the terms of agreements entered into between a finance company and lenders to it, either directly or through a trustee, copies should be furnished to the Inspector-General, but without in any way limiting his right to require information which he considers necessary to the proper discharge of his duties. Taking Atlantic Acceptance Corporation as an example, and referring only to the information required by lenders to that company, it may fairly be observed that the lenders failed to take advantage of modern methods of storing and retrieving it. Rather than rely on monthly and quarterly returns of information made by an office staff prone to err and subject to temptation to falsify, it would be preferable to require of a borrower

that all its loans, and information respecting its affairs which the lenders and regulatory authorities wish to know, be recorded on electronic data processing equipment. This was eventually conceded by the management of Atlantic Acceptance under pressure from its auditors, and the evidence is that such equipment was installed in November 1963, but was only used to a limited extent to supply information required by holders of notes issued under the Fourth Supplemental Indenture; for example, the programme was never applied to the operations of the Adelaide Street subsidiary companies. It may be that at this time there are no finance companies which do not to some extent employ this equipment, but the proposed regulatory authority should retain the services of an expert in computer programming to ensure that an appropriate programme has been adopted; monthly then, or at any other interval, all required information could be readily produced. As an additional precaution the auditors of a finance company could be asked to certify annually that sufficient details of the company's business were included in the memory banks of a computer, or make such comments upon any deficiency in programming as might be appropriate.

Only general comments can and, perhaps, should be made as to the nature and production of information which the Inspector-General should require for his own purposes, and perhaps make available to interested sections of the public upon request. It is unlikely that anyone will now lend money to a finance company without being furnished at regular intervals with information provided by the Robert Morris Associates Questionnaire and the Canadian Sales Finance Companies Long Form Report. The Inspector-General would undoubtedly require all that is furnished to lenders, and perhaps more for his purposes. In addition he might take care not to divulge information of a confidential nature which should not be withheld from him, but the publication of which might be damaging to the competitive position of an individual company, a consideration which has been for long recognized by the Board of Trade in the United Kingdom and provided for in the Companies Acts. Indeed the submission of their affairs to the scrutiny of a senior government official should be as advantageous to finance companies as to the public; in proper cases he would be in the position to explain their problems in knowledgeable terms to his political chiefs and civil service colleagues, as well as act as an adviser and interpreter of government policy to their managers, with all of whom in due course he would become well acquainted and able to assess their character and capacity. As far as the Commission has been able to judge, this has been generally the effect of the administration of successive Superintendents of Insurance and Registrars of Loan and Trust Corporations in Ontario, and of the Superintendent of Insurance at Ottawa.

RECOMMENDATION IX

*The Inspector-General should, in addition to such other information as he may request, be furnished with copies of all reports made by a finance company to lenders of money to it, and should be empowered to require that such information be provided by the use of electronic data processing equipment at the company's expense, to an extent and in such a manner as he considers satisfactory.*

## The Liability of Directors

In Chapter XVIII, under the heading "Proposed Legislative Change in Ontario",[1] I have made observations at some length upon the new burdens which will be laid upon the shoulders of company directors if the proposed Business Corporations Act 1968 is enacted in its present form. There I had occasion to comment on the radical change in the existing law which will be imported by the enactment of section 131 of the bill, the text of which may be conveniently repeated here with my own italics.

> 131. Every director and officer of a corporation shall exercise the powers and discharge the duties of his office honestly, in good faith *and in the best interests of the corporation,* and in connection therewith shall exercise the degree of care, diligence and skill that a reasonably prudent director or officer would exercise in comparable circumstances.

With the exception of the substitution by the draftsman of the bill of the word "corporation" for "company", this is word for word with what was recommended by the Select Committee on Company Law in chapter VII of its interim report, entitled "Duties and Responsibilities of Directors". Apart from the fact that it suffers from disadvantages which experience has shown attach to statutory provisions of a declaratory type, and uses such vague words as "reasonably" and "comparable"—a defect which must not be charged against the Select Committee which merely suggested the inclusion of a provision substantially in that form—the duty to act "in the best interests of the corporation", while always heretofore presumed, becomes, by the provisions of section 87 of the bill, one for which a director may be held liable in a derivative action brought by a shareholder. Section 87, quoted in full in Chapter XVIII of my report,[2] seeks to introduce into the company law of Ontario a burden upon directors of an exceedingly oppressive nature, now established in the State of New York and other jurisdictions of the United States of America. It denies to the court the right to exercise discretion in three matters long since devised for the protection of private rights: first, leave to bring the action may be sought and given

[1]pp. 1510-2.
[2]pp. 1510-1.

without any notice to the party to be sued; second, the court is prohibited from ordering security for costs, apparently on the assumption that it will be so irresponsible as to order payment of a sum so great as to preclude the possibility of proceeding further; third, by providing that, unless the action is dismissed with costs, judgment "may include a provision that the reasonable costs of the action are payable to the plaintiff by the corporation or other defendants taxed as between a solicitor and his own client", it deprives the court, unless the provision is altogether meaningless, of discretion as to the scale of costs to be imposed, and compels it to award the most onerous. The interim report of the Select Committee gives no explanation of why the intended plaintiff in such an action should be permitted to apply for leave to proceed without giving notice to the intended defendant, but a revealing observation on the subject is made by one of the learned academic authors of research studies, prepared for the use of the Committee, in another work[3] wherein he states: "Most importantly, the application is to be *ex parte* which will prevent a trial on the merits at the preliminary stage". One would think that this laconic pronouncement would be insufficient to justify a procedure which in the context of *ex parte* injunctions restraining strikes has, because of the denial of something as fundamental as notice, attracted a wealth of pertinent criticism. What possible harm could result from allowing the judge, on a preliminary application, the opportunity to discover from the representations of a respondent that there was some defect of status in the applicant which would halt the proceedings then and there, rather than have it emerge at trial after further time had elapsed and costs multiplied? Then again, why, by the denial of security for costs, should a defendant, who cannot otherwise be indemnified by the company of which he is a director for damages arising out of what may only be a mistake of judgment, be deprived of the opportunity of securing his costs if successful, even on the most modest scale, from a party who has frivolously proceeded against him? In fairness to the Select Committee, which makes no secret of the fact that "the wrongdoers will normally be directors and officers whose misfeasance or inaction has resulted in damage to the company of which they are the managers", the text of the interim report should be quoted at some length, taken from chapter VII.

> 7.4.2. As is well known, derivative actions in company law matters are common in the various United States and are the subject of statutory attention in a number of important American jurisdictions. In many or most of the United States, the rules of ethics of State and local bar associations apparently permit lawyers to act in civil litigation on a "contingency fee" basis. This has led to the so-called "strike bar" in the

[3]Studies in Company Law ed. Jacob S. Ziegel, Toronto, Butterworths 1967, Chap. 18 p. 598.

field of derivative actions against corporations. Further, plaintiffs frequently threaten to bring derivative actions or in fact commence them solely for the purpose of provoking secret settlements with the companies even in circumstances where the action is not well founded. In the result, the derivative action has achieved a notable degree of unpopularity in Canada and elsewhere. There is no doubt that this unpopularity is merited in many instances as the actions which have been commenced are frequently of an harrassing nature, brought in the hope that a judgment will carry with it a substantial award for lawyers' fees and expenses as is expressly permitted by the statutes of many States. The Committee is satisfied, however, that the undesirable characteristics of the derivative action can be avoided and that the remedy is one which can and should be adapted to Ontario law and practice to serve as an effective procedure whereby corporate wrongs can be put right.

7.4.3. The Committee therefore recommends that the Ontario Act be amended by adding a substantive provision to the effect that a shareholder of a company may maintain an action in a representative capacity for himself and all other shareholders of the company suing for and on behalf of the company to enforce any rights, duties or obligations owed to the company which could be enforced by the company itself or to obtain damages for any breach thereof. The Act should be further amended to set out the following procedural aspects of the substantive remedy. The shareholder should be required to sue in a representative capacity, it being clear that the judgment or award is to be in favour of and for the benefit of the company. As conditions precedent to the right to bring the action, the plaintiff should be required to establish that he was a shareholder of record at the time the wrong was alleged to have occurred and that he has made reasonable efforts to cause the company to commence or maintain the action on its own behalf. Further, the Act should provide that the intended plaintiff must make application *ex parte* to a judge of the High Court of Ontario designated by the Chief Justice of the High Court for an order permitting the plaintiff to commence the action. In practice, it can be assumed that the application will be supported by affidavit material which would include the draft writ of summons and statement of claim. The shareholder should be required to establish to the court that he is acting *bona fide* and that it is *prima facie* in the interests of the company or its shareholders that the action be brought. If, under proper circumstances, the court makes an order permitting the intended plaintiff to commence the action, no order shall be made as to security for costs although the judge would be free to make the order on such other terms and conditions as he sees fit. Keeping in mind, however, that the true plaintiff is the company, the nominal plaintiff should be permitted, while the action is pending, to obtain from a judge or the Master an order against the company for the payment of interim costs which would include, among other things, specified solicitor's and counsel fees. The plaintiff, of course, will be accountable to the company in respect of any such interim costs and, as is the case with any other plaintiff in our jurisdiction, runs the risk of the action being dismissed with costs against

> the plaintiff. In the opinion of the Committee, The Judicature Act would permit the judge at the trial to include in his judgment or order a provision that costs will be payable to the plaintiff as between a solicitor and his own client. However, if there is any doubt as to the correctness of this opinion or if there is concern that judges will not exercise their discretion to award such costs, the Act should specifically provide that the judgment rendered by the court can include an award to the plaintiff for his reasonable costs, including counsel and solicitor's fees and disbursements, incurred in maintaining the action. The Act should contain a provision comparable to that in the New York Business Corporation Law and in the law of many of the United States to the effect that any derivative action so brought shall not be discontinued, compromised or settled without the approval of the court, in the hope that "secret settlements" shall not be made.

It will be observed that, in the first paragraph quoted, there is a plain warning of the possibility of successful blackmail based on experience in the jurisdictions from which these recommendations are derived, and in the second paragraph, a plain acknowledgment of the Committee's indebtedness to the Business Corporation Law of the State of New York in which these vexatious consequences have been experienced to the full. Moreover the determination of the Select Committee to distrust the exercise of judicial discretion could not be more plainly expressed, and the recommendation in the last sentence of the second paragraph quoted, made "in the hope that secret settlements shall not be made", is the lamest possible conclusion upon which far-reaching legislation can be based. But the Select Committee has fairly stated the dangers inherent in the American derivative action by shareholders, and the wonder is not so much that it has succumbed to popular prejudice against the wicked company director, as that its recommendations should have been so promptly and faithfully introduced into the Legislature, despite its candid recital of the difficulties which their adoption in American jurisdictions have created. Indeed the difference in treatment by the revenue authorities for purposes of calculating income tax in the United States and Canada has apparently been overlooked, and the more liberal view prevailing in the former on allowance of deductions for damages awarded, or paid on settlement, has been at least one of the reasons why the business community there has been able to take a philosophical view of what in this country must inevitably produce hardship of the most grievous kind.

If the effect of sections 131 and 87 of the Business Corporations Act 1968 becomes the law of Ontario, a company director may find himself exposed to the payment of damages for the consequences of decisions made in good faith, and in what he conceived to be in the best interest of the company at the time, which, when a derivative action is subsequently brought, have in the opinion of the court adversely

affected the company's fortunes. In short he must pay for his honest mistakes of judgment and he cannot look for compensation to his company, or presumably to any fund provided by his company's insurers. Justification for this statement is found in section 134 of the bill.

> 134.—(1) Subject to subsection 2, the by-laws of a corporation may provide that every director and officer of the corporation and his heirs, executors, administrators and other legal personal representatives may from time to time be indemnified and saved harmless by the corporation from and against,
>
> *(a)* all costs, charges and expenses that he sustains or incurs in respect of any action, suit or proceeding that is proposed or commenced against him for or in respect of anything done or permitted by him in respect of the execution of the duties of his office; and
>
> *(b)* all other costs, charges and expenses that he sustains or incurs in respect of the affairs of the corporation. R.S.O. 1960, c. 71, s. 72, *amended.*
>
> (2) No director or officer of a corporation shall be indemnified by the corporation in respect of any costs, charges or expenses that he sustains or incurs in or about any action, suit or other proceeding as a result of which he is adjudged to be in breach of any duty or responsibility imposed upon him under this Act or under any other statute or rule of law or equity unless, in an action brought against him in his capacity as director or officer, he has achieved complete or substantial success as a defendant.

Here it is to be seen that what is offered with one hand in subsection 1 is effectively taken away by the other in subsection 2. The unfortunate and foreseeable result of this legislation, if finally enacted in its present form, is that company directors in Ontario may look forward to a life of insecurity and peril, and that company promoters will ponder the advisability of seeking incorporation in a jurisdiction where their operations, however honourable in intent, will be full of hazards. They will not ponder long.

In deference to this Commission's terms of reference I will confine myself to making recommendations about the proposed derivative action to the situation of finance companies. In view of what has been said at somewhat tiresome length, I can do no less than recommend that the results of actions and decisions of directors of these companies should not be actionable if done and taken in good faith. Thus the form of the derivative action may be retained if it is considered wise to do so, but the possibility of extortion will be much reduced. I must be forgiven if I also recommend that the discretion allowed to judges for many years, and without noticeable ill-effect, be suffered to continue in matters such as notice to be given to intended parties to an action, the ordering

of security for costs, and the scale of costs which should be awarded against an unsuccessful party, depending upon his behaviour before and during the course of an action in accordance with the findings of fact. This discretion may be reviewed if it is not judicially exercised. I can see no reason why the board of directors of a company, with the approval of the shareholders expressed in the usual and acceptable way by a vote of the majority, cannot provide for the indemnification of one of their own number, or an officer of the company, for any loss suffered from damages awarded against him in a court of law, provided that they arise from an action taken or a decision made on behalf of the company in good faith. Recommendations made to this effect may, one would hope, prove to be unnecessary.

RECOMMENDATION X

1. *No action should be brought against any director or officer of a finance company to enforce any right, duty or obligation owed to his company only on the grounds that an action taken or decision made by him was not in the best interests of the company, unless it is alleged that such action was taken or decision made fraudulently, negligently or in bad faith.*
2. *In any such action, notice, security for costs and costs should be in the discretion of the court.*
3. *Indemnification by a finance company of any director or officer against pecuniary loss, suffered as the result of an action brought by a shareholder of such a company in a representative capacity on behalf of the company against him, should be a question for its shareholders other than such director or officer.*

**Borrowing under Deeds of Trust**

The question of the compliance of Atlantic Acceptance with the covenants of the various trust deeds securing its notes, entered into with the Montreal Trust Company as trustee, has been dealt with at length in Chapter XVI, at the conclusion of which I made observations in some detail about the possible effect of sections 56 to 61 inclusive of the Business Corporations Act 1968, if enacted into law, which need only be briefly referred to here. Both finance companies and trust companies are closely concerned with the effect of any change in the law contemplated in terms of these sections; finance companies are the most consistent issuers of obligations secured by deeds of trust, and trust companies are invariably the trustees under such instruments. In the case of the former it is probable that they will turn away from borrowings secured in this fashion, as their counterparts in the United States have turned away, as the burdens laid down by statute on trustees are increased to the point where the cost of their services becomes an item of

consequence in borrowing expense; but if by statute or regulation they are compelled to issue their obligations secured by a trust deed and pay the increased price for doing so in Ontario, they will be forced, in order to remain competitive in the money market with borrowers more fortunately situated, to seek the shelter of jurisdictions where statutory and regulatory requirements are less burdensome. For the same reasons Ontario trust companies will do less of the work of trustees, for which they are peculiarly fitted, and which, as is generally agreed, they should be encouraged to undertake in greater measure. As already observed, the provisions of section 60, under which a trustee is prohibited from acting as receiver or receiver and manager or liquidator of the assets or undertaking for a borrower on behalf of whose lenders it had covenanted to act, are particularly unfortunate, not only as constituting another example of depriving the courts of their discretionary power, but because the trustee in such a situation, by reason of the knowledge and experience acquired of a borrower's business and assets, is a logical choice as receiver in case of default, and one which lenders are generally disposed to make. There may be justification for disqualifying individuals in such a situation, for the reasons given in "Kerr on Receivers" as having from time to time convinced the courts in England where companies are not allowed to act in that capacity. In Ontario corporate trustees are under no such disability, are admirably organized to do the work and are unlikely to hazard their hard-won reputations by doing it improperly under the supervision of the court. I have already pointed out the fact that this distinction was overlooked by the Select Committee, and it was not likely to be brought to their attention in the United Kingdom where trust companies like ours are unknown. The appeal to English authority, useful and appropriate as it often is, is, in this case, irrelevant. Again, on the assumption that these sections of the Business Corporations Act 1968 may become law in this province, I am constrained to adopt the artificial stance of making a negative recommendation in a form limited to the effect of their provisions on finance companies and trust companies with which this Commission is expressly concerned. The effectiveness of Ontario finance companies, and their ability to borrow on competitive terms in the money market, are equally at stake.

### RECOMMENDATION XI

1. *No restriction by way of legislation or regulation should be placed on the freedom of a finance company to contract with lenders to it for the repayment of money lent.*
2. *Where application is made for the appointment of a receiver, receiver and manager or liquidator under the terms of any agreement entered into by a finance company as the borrower of money and the lenders*

*to it, or their trustee, such appointment should be in the discretion of the Court.*

3. *The lawful requirements of the Inspector-General for the provision of information about the borrowing and lending of finance companies should not be regarded as a restriction contemplated in 1, and notice of any application made under 2 should be given to the Inspector-General, so that he may attend upon the return of the application before the Court and make such representations as he deems necessary.*

* * *

**Postscript: The Proposed Investment Companies Act of Canada**

Since writing of the foregoing comments and recommendations on the subject of legislation applicable to finance companies the Investment Companies Bill, or Bill S-17, has been read the third time in the Senate of Canada on June 25, 1969. It is only necessary to read the speech of the Honourable Salter A. Hayden, reporting on it as chairman of the Standing Committee of the Senate on Banking, Trade and Commerce,[1] to realize that this is yet another enactment which owes its existence to the failure of Atlantic Acceptance and other companies, either genuinely or ostensibly carrying on finance company business.

> "The real intent of the bill is to close a gap which exists in the present law. The fact that there is a gap, certainly at the provincial end, was indicated, for instance, by the failures of Atlantic Acceptance, Prudential, and Commonwealth Trust, which borrowed money on the security of bonds, debentures, notes, or other evidences of indebtedness, and then invested that money in various ways. What went wrong in Atlantic Acceptance is of course a well-known story. Money was borrowed to a great extent, and supervision was non-existent even though the borrowing was, in many instances, from what we might call sophisticated lenders. There was no supervision in the ordinary way of the investments which were made, as was ultimately established in the loss of substantial amounts of money to the lenders.
>
> The federal authority felt that the companies that had been involved in this sort of thing were provincial companies, but that they should tighten up the federal law so as to cover that situation by providing for reporting, inspection and control by registration. So this bill S-17 came in."

The bill, of course, will apply only to companies incorporated by or under the authority of the Parliament of Canada, but since it goes considerably further, not only in the severity of regulation and control but also in statutory prohibition, than I have thought fit to recommend

[1]Debates of the Senate: 1st Session, 28th Parliament, Volume 117, Number 88.

in the case of Ontario finance companies, I feel it necessary to make some observations upon it, conscious as I must be of the difficulty of doing so in the case of a bill which is still to be considered by the House of Commons. Although the bill has a general application to companies carrying on "the business of investments", the fact that this is defined as the borrowing of money on the security of bonds, debentures, notes or other evidences of indebtedness, and the use of it by making loans, whether secured or unsecured, or purchasing securities, real property and instalment sales contracts to an amount which is in excess of 40% of the lender's assets, makes it of particular concern to companies carrying on regular sales finance business. It would appear that the bill as introduced was intended to provide mainly for "reporting, inspection and control by registration", as Senator Hayden said in his remarks quoted above, but he went on to describe what must be considered rigorous amendments added to its provisions by the Committee and incorporated in its final form.

> "In addition we took advantage of the sanctions incorporated in the four bills that came to us, the Canadian British Insurance Companies Bill, the Foreign Insurance Companies Bill, the Trust Companies Bill and the Loan Companies Bill, and we borrowed those sanctions which were much tougher than in Bill S-17 as it came to us, and we added those to the others in Bill S-17. The result was that if the Superintendent at the stage that he is investigating, comes to the conclusion that there is something radically wrong and if steps are not taken at once there may be a dissipation of assets, and if a report is made and they are required to come to the Minister to give their explanation, who knows what hand might be in the till, and by the time you took effective possession through bankruptcy proceedings or winding up proceedings you would have possession and authority but you would not have the assets. So we adopted it, giving a clear right of way to the provision so that when the Superintendent of Insurance, as a result of his investigations and when he has discussed it with the Minister, concludes that the first step that should be taken is essentially a step to protect the assets, he can move in right away and take possession of them. This initial step is being taken in the interests of the lenders of the money.
>
> Having done that, the other sections provide for further investigation giving rights to the company affected by this and giving them the right to appeal to the Exchequer Court, which appeal is final. The essential thing is to preserve whatever assets there may be, to insure that there is no further dissipation. The Superintendent went along with this. He said, 'How can I object to putting it in Bill S-17 when I put it in these four other bills?' We thought that that was a pretty strong argument in our favour. That was accepted."

Two points arising from this portion of the Senator's speech invite comment. In the first place the Superintendent of Insurance might have

observed that the sanctions bestowed by bills dealing with trust companies, loan companies and insurance companies were primarily justifiable because of the need to protect depositors in the case of trust and loan companies, and those paying premiums on policies of insurance who, because of the character of savings with which these are invested, can be considered to be in an analogous position. The sanctions referred to, which will be considered in more detail later when the amendments to the Trust Companies Act of Canada are discussed, may be briefly described as conferring on the Superintendent the right to take control of the assets of the companies concerned when he feels that these have not been properly accounted for. The position of investors in the shares and obligations of finance companies is recognizably different, and it is submitted, with respect, that, given adequate disclosure to the regulatory authorities so that they are in a position to inform investors and lenders of apparent delinquencies or, intervene with the borrowers themselves, the placing of the Superintendent in a position where he may be bound to assume control of an enterprise with no fiduciary functions is difficult to justify. One argument against this course, which may have been advanced before the Senate Committee but was not referred to on third reading, is that any assumption of control of a borrower's assets in a case where these are pledged under a deed of trust might be construed by the lenders and the trustee as an event of default, in which case all the debt would become due and payable and any rehabilitation by the Superintendent or the Minister would be at once frustrated. On the other hand, it must be recognized that conferment of these powers—in sections 14 and 15 of the bill—provides a humane alternative to cancellation of a company's registration or revocation of its licence, as the case may be, and understandably the need to provide one weighed heavily with those who framed the legislation; closing the doors of a company would precipitate default more surely than any other expedient. Under the circumstances contemplated by my Recommendation VIII.6, it is to be hoped that the terms imposed by the Lieutenant Governor in Council would provide for the orderly liquidation of a company's debt, and against precipitate action by its creditors, however authorized by any deed of trust.

In the second place, the right of appeal to the Exchequer Court of Canada, which is provided for in section 15 of the bill, is from the decision of the Minister to impose conditions upon a delinquent company under which alone it may continue in business, to cancel its registration or to direct the Superintendent to maintain his control of all, or any part, of its assets. A similar provision in the proposed Business Corporations Act 1968 of Ontario is to be found in section 254 of that bill, which provides that any person who feels aggrieved because of the decision of the Minister in that case to refuse to file articles of incorporation of a

company or, having filed, to revoke them, may appeal to the Court of Appeal. In both bills it is provided that the courts may either affirm the Minister's decision or rescind it, and substitute their own opinion of what his decision should have been. I have hitherto avoided any comment on this subject, but since it is becoming fashionable to provide rights of appeal so that everyone aggrieved can have a second chance, I cannot refrain from observing, with the greatest deference possible, that this type of provision appears to constitute a radical departure from existing constitutional principle and practice. If it were contemplated that the court should only review the decision of a minister to establish that his discretion had been exercised properly, within the four corners of the statute in question, no departure from principle would be evident, but, according to the plain meaning of these sections, the courts are now to be committed to making pronouncements about what are evidently questions of government policy; moreover parties to such appeals, which, of course, would include the Minister, are not to be allowed to seek the direction of the Supreme Court of Canada as to whether these courts have properly exercised their appellate function within the limits of their jurisdiction. Whether it is any less undesirable for the courts to be able to frustrate the policy of the executive than it is for the executive to interfere with established judicial process is a question which should provoke serious debate.

A further observation at this late date must also be made. Section 8 of the bill may be paraphrased as providing that no investment company shall knowingly lend money to a director or officer, their spouses or children, or to a substantial shareholder, or invest in a corporation in the latter category, or invest in a corporation in which any such individuals or corporations have a significant interest. The section is a long one, and goes on to stop all the current gaps which ingenuity might expect to find in such a sweeping provision. Some relief is provided by subsection 4 which gives the Minister the power to exempt certain investments otherwise prohibited, "if he is satisfied that the decision of the investment company to make or hold any investments so exempted has not been and is not likely to be influenced in any significant way by that person or group and does not involve in any significant way the interests of that person or group apart from their interests as a shareholder of the investment company". This section, which, of course, will speak for itself, when and if enacted, has a direct bearing on the subject of conflict of interest, which I have earlier discussed in relation to the effect of section 122 of the proposed Business Corporations Act 1968 and my own Recommendation VII. There I have indicated that the propriety of transactions where an interest has been declared should be left to the shareholders, and I take the liberty of suggesting that, in order to foster self-regulation and a sense of responsibility among businessmen, this

solution is preferable to statutory prohibition which may be waived by ministerial exemption, thus confronting a minister with the necessity of deciding whether to enforce the statute with resolution, or weaken its effect by exercising his discretionary powers.

* * *

**British Mortgage & Trust Company**

Treatment of the affairs of British Mortgage & Trust Company, from the time that Wilfrid P. Gregory assumed responsibility for their management in 1957 to the time of its amalgamation with Victoria and Grey Trust Company, on terms which obliterated its name and effectively destroyed the equity of its shareholders, has been, generally speaking, confined to Chapter XV, but because of the close connection between Gregory and C. P. Morgan, and the involvement in consequence of British Mortgage in the tangled affairs of Atlantic Acceptance Corporation and the companies which it either controlled or dominated, there have been numerous references in other chapters of the report to the trust company and its officers. A summary of my conclusions has already been given in Chapter XV under the heading "Concluding Reflections",[1] and need not be repeated here. Suffice it to say that the causes of what was, in fact, the failure of British Mortgage & Trust were directly attributable to two of Gregory's preoccupations: the first was a human but obsessive tendency to seek the company's aggrandizement in every department of business which would produce a striking financial report and enhance the value of the company's shares; the second arose from his infatuation with Morgan's companies, and Morgan's methods of doing business, which led him to commit a perilously high proportion of the company's investments, and even of its estates, trust and agency accounts, to the fortunes of the Atlantic complex, in the course of which he set at nought sometimes the letter and invariably the spirit of provisions of the Loan and Trust Corporations Act designed to prevent a dangerous concentration of loans by trust companies to any one related group of borrowers. The first of these preoccupations, by creating a large and progressively larger portfolio of mortgages, and the establishment of branch offices at an unprecedented rate through which more mortgages were garnered and savings deposits accumulated, resulted in a dangerous loss of liquidity; and the second put so many eggs into the wrong basket that, when these were broken by the collapse of Atlantic Acceptance, the company was unable to meet its commitments to its depositors and guaranteed investors, and without the assistance of the

[1]pp. 1260-5.

government of Ontario would have been forced to close its doors. It is thus apparent that the tribulations of British Mortgage & Trust Company can be directly related to the extent to which it did not comply with the provisions of legislation specially designed to prevent what in fact happened, and to certain imperfections in the Act which hampered the Registrar in his efforts to enforce compliance, and which Gregory eagerly exploited. The relevant provisions of the Act have been reproduced and commented on at some length in Chapter XV, and the nature of Gregory's controversy with the Registrar has also been there treated in copious detail. It is now necessary to return to the subject with a view to considering what improvements can be made.

**The Loan and Trust Corporations Act**

I have referred before to the fact that the Loan and Trust Corporations Act has been frequently amended since the collapse of Atlantic Acceptance. Important amendments were made in 1965, receiving Royal Assent on June 22, but could not, of course, reflect the plight of British Mortgage & Trust Company, and, by the same amending act, trust companies were permitted to increase loans made on the security of mortgages of real estate from two-thirds to three-quarters of the value of the land in question. For the first time, however, a limit was placed on the amount of funds which a trust company could hold in the form of deposits and for guaranteed investment, and in respect of which the company was deemed to be trustee for both depositors and investors. This was contained in section 82*a*:

> 82*a*—(1) The total of the sums of money received as deposits under section 80 and for guaranteed investment under section 82 shall not at any time exceed an amount equal to the aggregate of its cash on hand or deposited in chartered banks in Canada and of four times the combined amounts of its then unimpaired paid-in capital and reserve, but the Lieutenant Governor in Council may, on the report of the Registrar and upon such terms and conditions as are prescribed, increase the amount that may be received to a sum not exceeding an amount equal to the aggregate of such cash and fifteen times the combined amounts of such capital and reserve.
>
> (2) In ascertaining the amounts that may be received by a trust company under subsection 1, all loans or advances to its shareholders upon the security of their shares shall be deducted from the amount of the paid-in capital.

This section has not yet been proclaimed in force, and the reasons for not doing so may include a suspicion that the limitation of cash plus 15 times the combined amounts of unimpaired paid-in capital and reserve, subject to the favourable recommendation of the Registrar and approval

by the Lieutenant Governor in Council, may be too high,[1] and may constitute an invitation to the newer and smaller trust companies to achieve a position which may be reflected thus:

| *Assets* | | *Liabilities* | |
|---|---|---|---|
| Cash | 3 | Deposits and G.I.C.'s | 1503 |
| Investments | 1600 | *Capital* | |
| | 1603 | Capital and reserves | 100 |
| | | | 1603 |

It will be seen that a decline of 6¼ % of the value of investments in this case, without a compensating increase in cash, would destroy the company's capital and reserves and, if it is said that this represents a very drastic reduction in the value of the type of investment to which trust companies are by law confined, a glance at current prices for bonds of Canada and its provinces, and of municipal and corporation bonds, will show how narrow the margin of safety is. Of course progressive impairment of paid-in capital would, in theory, have to be matched by a reduction in the amount of deposits and guaranteed investment certificates and, if there were time to do this in an orderly way, the danger might be averted.

The mortgage lending ratio was not disturbed by the Loan and Trust Corporations Amendment Act[2] but in other respects the provisions of the Act reflected public concern with the demise of British Mortgage & Trust Company. Sections of the Corporations Act requiring disclosure of "insider trading" were made applicable to loan and trust companies, and an amendment was made to section 84 to improve the liquidity of the reserve held against deposits and guaranteed investments. The provisions of section 84 of the Act supply a comparison of what was required during the last years of British Mortgage & Trust with what is now the law established by the amendments of 1966, which were again amended in 1968[3] and indicate the importance of these changes. Section 84, as it appeared in the Revised Statutes of 1960 and remained unamended until 1966, was as follows:

> 84. Every trust company shall at all times maintain cash on hand and on deposit, debentures, bonds, stocks or other securities of a kind referred to in subsection 3 of section 150 and loans payable on demand and fully secured by such securities, to an aggregate amount of at least 20 per cent of the amount of money deposited with the company in the manner authorized by subsection 1 of section 80. R.S.O. 1960, c. 222, s. 84.

[1]The ratio currently being advocated by the Trust Companies Association and under consideration by the Parliament of Canada is 20 times this amount.
[2]S.O. 1966 c. 81.
[3]S.O. 1968 c. 66 s. 4(1)(2) and (3).

The combined amendments of 1966 and 1968 produced the following change:

84.—(1) Every trust company shall at all times maintain,

*(a)* cash on hand or on deposit in a chartered bank;

*(b)* unencumbered debentures, bonds, stocks or other securities of or guaranteed by the Government of Canada or of or guaranteed by any province of Canada or of any municipal corporation in Ontario or city in Canada;

*(c)* loans payable on demand and fully secured by a class of security referred to in clause *b,* and

*(d)* subject to the approval of the Registrar and to such conditions as the Registrar imposes, a credit from chartered banks in Canada,

to an aggregate of at least 20 per cent of the amount of deposits and of funds received for guaranteed investment coming due in less than 100 days.

(2) Of the amount maintained under clauses *a, b,* and *c* of subsection 1,

*(a)* at least 25 per cent shall be maintained in cash on hand or on deposit in a chartered bank and in unencumbered debentures, bonds, stocks or other securities of or guaranteed by the Government of Canada, maturing in three years or less; and

*(b)* at least 50 per cent shall be maintained in cash on hand or on deposit in a chartered bank and in unencumbered debentures, bonds, stocks or other securities of or guaranteed by the Government of Canada, maturing in ten years or less.

These amendments not only recognize the importance of increased liquidity in reserves behind deposits and funds received for guaranteed investment, but also one of the besetting sins of draftsmanship in the Act, illustrated by the necessity of reading section 84 in its former form in conjunction with four other sections. For instance subsection 3 of section 150 deals with semi-annual returns by trust companies as to deposits and liquid securities available, and lists securities of, or guaranteed by Canada and of, or guaranteed by any province of Canada, less any encumbrances thereon, securities of any municipal corporation in Ontario, or of any city in Canada, less any encumbrances thereon, and the bonds or debentures issued by any company incorporated in Canada, receiving subsidies from Canada or any of its provinces sufficient to pay interest or principal to a trust company, as trustee for the holders of such bonds or debentures. The subsection refers also to subsection 1 of section 80, which is subject to section 139 which, in turn, must be read in conjunction with subsection 1 of section 137. The "unravelling" process of discovering what a section means in the Loan and Trust Corporations Act has been referred to with feeling in Chapter XV, and one may pause here to say that, while it has undoubtedly led to the creation of a knowl-

edgeable fraternity of government and trust company officials, it is one which might well be eliminated from any revision of the Act. In fact simplification would be the obvious result of enacting separate statutes dealing with loan companies and trust companies, such as existed in Ontario before 1912 and prevails in the federal jurisdiction at the present time.

In Chapter XV I attempted a paraphrase of the complicated section 142, providing for restrictions on investments by a trust company,[4] and commented also on the effect of an amendment made to it in the statute of 1966[5] in so far as the limitation on the amount of money to be invested in any one company was extended to any company associated with it, the word "associated" being elaborately defined, not only in the amending section, but by reference to the definition of "related person" as defined in section 1 of the Corporations Tax Act.[6] At the same time the limit on an investment of this type, maturing in one year or less, added to any maturing in more than one year, was lowered from 20% of the registered trust company's paid-in capital stock and reserve funds, plus 5% of moneys received as deposits and for guaranteed investment, to 20% and 2½% respectively. Although these amendments to section 142 were intended to prevent trust companies concentrating investments and loans in one concern, such as the Atlantic complex proved to be, the thorny question of what constitutes "reserves funds" or "reserves", which led to capitulation by the Registrar's staff on one of the main points in Wilfrid Gregory's argument, has not been settled. It has already been suggested, and it is repeated here, that a distinction should be made between unallocated or general reserves and allocated or specific reserves, and that the latter, such as reserves for mortgages, should be excluded from the calculation in every case if these ratios are to be maintained. Since it has been seen that loans were made by British Mortgage & Trust, expressed to mature in one year or less, but were not called for payment, and since upon payment it was easy to renew them, the distinction drawn between an investment maturing in more than one year and one maturing in less could well be abandoned.

Among the other amendments introduced in 1966 was one to section 139(4) *(b)*, already noted in Chapter XV,[7] to enforce the Registrar's view that a trust company, under the provisions of section 139 read in conjunction with those of section 137, could only invest in shares which had a continuous record of paying dividends for seven years, and only to the extent of 80% of their market value. The question of what constitutes "market value" is still open, and was one which plagued the Registrar in his efforts to apply these provisions to investments by British

[4]pp. 1008-10.
[5]p. 1170.
[6]R.S.O. 1960 c. 73.
[7]p. 1026.

Mortgage & Trust in shares for which there was no real market. There was also another amendment to section 137(1) *(i)* which was applicable to the powers of investment of a trust company by the provisions of section 139, and dealt with the qualification of preferred stocks by their dividend record, also referred to in Chapter XV.[8] One of the most important from the point of view of the Registrar, and the need for which was the subject of concern by this Commission as a result of evidence given before it, was the enactment of section 117 *(a)* which reads:

> 117*a*—(1) The Registrar may address any inquiries to any corporation registered under this Act or to the president, manager or secretary thereof for the purpose of ascertaining its condition and ability to meet its obligations, and it shall be the duty of any corporation so addressed to promptly reply in writing to any such inquiries.
>
> (2) The Registrar may, in his discretion, embody in his annual report to the Minister the inquiries made by him under this section and the answers thereto.

It was also considered necessary, no doubt with the conduct of Wilfrid Gregory in mind, to add an additional subsection 3 to section 141 providing that:

> (3) No director or other officer of a corporation and no member of a committee of a corporation shall accept or be the beneficiary of any consideration or benefit for or on account of the negotiation of any loan, deposit, purchase, sale, payment or exchange made by or on behalf of the corporation.

The semi-annual returns of trust companies showing cash and liquid securities, "ear-marked and definitely set aside", for securing deposits and guaranteed investments coming due in less than 100 days were, by a further amendment to subsection 3 of section 150, required to be made quarterly to the Registrar. The provision that a corporation "shall not lend or advance money to any of its directors or auditors or to the wife or child of any director or auditor" in section 148 was expanded, first, to recognize the possibility that the director or auditor might be a woman, and, second, to extend the prohibition to loans to a company "if more than one-half of the shares of the capital stock of the company are owned by a director or auditor of the corporation or by the spouse or a child of such director or auditor, or by any combination of such persons". Finally, section 131, which forbade the registration of a trust company to transact business in Ontario "that has not a capital paid-in of at least $100,000" was re-enacted to provide that, after January 1, 1966, the prohibition should extend to trust companies that had "capital paid-in and unimpaired of at least $500,000".

The only amendment made in 1967 was to the definition of "ac-

[8]pp. 1038-9.

countant" in section 1, to reflect changes in the constitution of the accounting profession, but the Legislature returned to the charge in 1968[9] with the Loan and Trust Corporations Amendment Act 1968, which included provisions that the unimpaired paid-in capital of a trust company, after January 1, 1968, should be at least $1,000,000, and, by amendment to section 84, adding to the securities therein specified by clause *d* "subject to the approval of the Registrar and to such conditions as the Registrar imposes, a credit from chartered banks in Canada". These amendments came into force when the Act received the Royal Assent. As may be seen from the submission of the Trust Companies Association of Canada to the Commission, delivered at a public hearing on October 4, 1967,[10] which may be read as Appendix P[11] to this report, most of these amendments were approved of by the Association and, indeed, some had been suggested by it. As might be expected when the complete revision of a statute is contemplated, and various official and professional bodies have been invited to make recommendations on what it should contain, the amendments referred to above were calculated to patch up the Act in places where it had become threadbare, and where there were gaps allowing adventurers in the industry to drive boldly through. Some deficiencies of the Act still await attention which may be forthcoming when new legislation is introduced, but which should be briefly mentioned here. To the terms requiring definition, such as "reserve funds", "reserve" and "market value", must be added "improved real estate", mortgages of which are permitted to trust companies. British Mortgage & Trust from time to time lent money on mortgages of land which was merely idle farm property in the hands of a developer. Wilfrid Gregory was quite candid about his excursions into this field of "interim financing". The first definition of this expression by any jurisdiction in Canada prescribing permitted investments for trust companies has come from Alberta, where the new Trust Companies Act 1967 provides, by section 2(1)16, the following definition:

> 16. "improved real estate" means real estate
>
> (i) upon which there exists a building used or capable of being used for residential, commercial, industrial, educational, religious, charitable or recreational purposes, or
>
> (ii) upon which such a building is being constructed, or
>
> (iii) which is provided with the utilities necessary to serve such a building with electric power, water and sewers but only when the land is being mortgaged for the purpose of financing the construction of such a building, or
>
> (iv) on which actual farming or ranching operations are being conducted;

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[9] S.O. 1968 c. 66.

[10] Evidence Volume 126.

[11] Exhibit 4918.

The adoption of a careful definition of this type, though not necessarily in these terms, is long overdue in Ontario, unless it is concluded that there is in fact no need to draw any distinction between real estate and improved real estate. Another peculiarity of the Act about which evidence was given to the Commission, and upon which I have commented in Chapter XV,[12] is the absence of any requirement that the auditors express an opinion on the operating, or profit and loss statement, as they are required to do on the balance sheet by the provisions of subsection 2 of section 68. The nature of the controversy on this subject, and the reasons for making a change in the Act, as recently as 1960, to exclude the requirement of an auditor's report upon a trust company's profit and loss statement, have been fully discussed, and I conclude that the latter are no longer valid at a time when the fullest disclosure is being urged, and, indeed, imposed upon all corporations, even though such disclosure should reveal, to shareholders and the public, transfers from general reserve to income made to maintain an appearance of profitability from year to year. Such a conclusion is reinforced by the change of treatment in the case of chartered banks embodied in section 60 of the revised Bank Act.[13]

Reference to Appendix P will disclose some reluctance on the part of the Trust Companies Association to accept a thorough revision of the Ontario Loan and Trust Corporations Act before completion of certain studies, now in progress at Ottawa, by a sub-committee of the Federal-Provincial Conference on Financial Institutions, in Quebec, by the Study Committee on Financial Institutions and, presumably, by the Select Committee on Company Law and this Commission in Ontario. It seems to me that the Association is justified in expressing the need for caution when it finds the Act as it now is substantially satisfactory, and well understood by those who have to work with it.

## The Scheme of the Present Act

The scheme of the Ontario Loan and Trust Corporations Act, as at present constituted, may be briefly referred to. First of all there are provisions in unusual detail dealing with the application of the Act, the incorporation of loan and loaning land corporations and trust companies, the holding of meetings of shareholders, the qualifications, powers, liabilities of directors, capital stock, books, and auditors; these provisions reflect the peculiar status of the companies involved, their "building society" background and, by section 17, the obligation to establish public need for their creation. The borrowing powers of loan and loaning land corporations are dealt with in sections 70 to 76 and the analagous "powers of trust companies", which are not supposed to borrow "by accepting deposits", as the gloss in section 79 has it, or as

[12]pp. 978-81.
[13]S.C. 1966-67 c. 87.

the section itself says "to take deposits by way of borrowing money", in sections 77 to 84. Certain powers common to all types of corporations dealt with by the Act are contained in sections 85 to 96. The procedure prescribed for amalgamating corporations, and for purchasing or selling the assets or shares of a corporation by or to another, is laid down at some length in sections 97 to 108, and the main requirements governing such transactions are, first, that they shall be approved of by the Lieutenant Governor in Council and, second, that in the case of a purchase of shares leading to merger, over 67% of the outstanding shares must be transferred, and, whether shares or assets are transferred, the approval of holders of at least three-quarters of the shares amounting to not less than half of the issued capital stock of the participating companies must be obtained at meetings specially called to consider the question. These provisions are otherwise concerned with the protection of depositors, as well as, in the case of loan corporations, of holders of debentures and, in that of trust companies, of guaranteed investors and beneficial owners of assets under administration.

The powers and duties of the Registrar of Loan and Trust Corporations are set out in sections 109 to 118, followed by provisions governing the registration of corporations in sections 119 to 132, and containing, in sections 124, 125 and 126, authorization of the power of the Registrar to suspend or cancel the registry of any corporation for cause, and of the right of a corporation affected by such a decision to a "hearing and review" by the Registrar and to appeal his decision to a judge of the Court of Appeal. The disabilities of unregistered corporations and unauthorized persons, and the penalties attaching to their transaction of business reserved to registered corporations, are set out in sections 133 to 136.

There follow, under the heading "Investments", sections numbered 137 to 149 which are the heart of the Act. Section 137 prescribes the powers and types of investment permitted to loan and loaning land corporations, and section 139 does the same for trust companies, largely by reference to section 137. The restrictions on investments are designed to protect depositors, debenture holders and guaranteed investors, as are the liquidity requirements previously referred to, the emphasis being on quality rather than liquidity. Sections 138 and 140 are the so-called "basket clauses" for loan corporations and trust companies respectively; they provide for investment of a company's own funds, and in the case of a trust company, moneys received for guaranteed investment and as deposits, in securities and as loans in amounts which "so long as the total book value of the investments and loans so made and held by the company, excluding those that are or at any time since acquisition have been eligible apart from this section, do not exceed 15 per cent of the company's unimpaired paid-in capital and reserve". Section 142, designed

to prevent an undue concentration of investments or loans in or to any one company, or group of associated companies, has been discussed at length. Some further exceptions to the permitted categories are contained in sections 143 to 147 in the case of securities obtained as a result of various transactions, including amalgamation with or acquisition of other companies of like status, on condition that they be sold within five years, and in the form of real estate held for sale, or for a company's own use, provided that the investment does not exceed 35% of the "paid up capital and reserve funds". Finally, section 149 provides that the Registrar may require any company to dispose of investments not authorized by the Act, and that the directors shall be liable for any deficiency in the realization of such investments, except where any director may have entered a protest against the making of them and has so advised the Registrar. The returns required from loan and trust companies made to the Registrar and the certificates in connection with them are specified in sections 150, 151 and 152; miscellaneous provisions dealing with the disposal of deposits on the death of a depositor, winding-up of companies and the like, are set forth in sections 153 to 158, offences and penalties in sections 159 to 161, and fees in section 162.

There are thus three main heads of regulation; the first is concerned with the creation and regulation of the life of a company, the second seeks to protect demand and term deposits by imposing a limitation on their maximum amount, calculated in relation to the holder's unimpaired capital and reserves, and the third to ensure the financial stability of a corporation registered under the Act by prescribing permitted investments, the ratios such investments bear in relation to the security taken, and in the case of liabilities for which a corporation is deemed to be a trustee, specific requirements to maintain their liquidity.

### Deposit Insurance

Since the aim of all this regulation was to protect depositors, and holders of obligations which gave them the same status, the need for compulsory insurance of deposits imposed by legislation was deprecated by the Trust Companies' Association of Canada, as perusal of Appendix P will make clear. Nevertheless, in 1967 the government of Ontario took the lead in establishing a compulsory scheme to be administered by a Crown corporation with respect to the deposit-taking corporations under its jurisdiction; this step was closely followed by the government of Canada and in fact the Canada Deposit Insurance Corporation Act[1] received the Royal Assent only one week after the Ontario Deposit Insurance Corporation Act.[2] Whereas the Ontario act applied only to

[1]S.C. 1966-67 c. 70.
[2]S.O. 1967 c. 61.

loan corporations and trust companies incorporated under the laws of the province and registered under the Loan and Trust Corporations Act, described as "member institutions", the federal act embraced banks under the Bank Act and the Quebec Savings Bank Act, and trust companies and loan companies to which the Trust Companies Act and the Loan Companies Act of Canada apply. By an amendment, assented to on April 26, 1967, Ontario effectively subjected its member institutions to the insurance scheme administered by the Canada Deposit Insurance Corporation, a step which the Province of Quebec has not at the time of writing seen fit to follow.

22.—(1) Every member institution is authorized to apply to the Canada Deposit Insurance Corporation for deposit insurance under the *Canada Deposit Insurance Corporation Act.*

(2) The Minister on behalf of the Province may enter into agreements with the Canada Deposit Insurance Corporation for any purpose in connection with the issuing of policies of deposit insurance to loan corporations and trust companies incorporated under the laws of Ontario.

(3) Any such agreement may contain an undertaking by the Province to indemnify the Canada Deposit Insurance Corporation for any loss to that corporation occurring by reason of its obligation to make payment in respect of any deposit insured by a policy of deposit insurance where the obligation arises during the period specified for that purpose in such agreement.

23.—(1) No loan corporation or trust company registered under *The Loan and Trust Corporations Act* shall after the 30th day of June, 1967, accept, receive or issue deposits unless it holds a certificate or policy of deposit insurance issued by the Canada Deposit Insurance Corporation or unless its deposits are insured in some other manner approved by the Lieutenant Governor in Council.

(2) In the case of any particular loan corporation or trust company the Lieutenant Governor in Council may extend the time for effecting the insurance mentioned in subsection 1.

23*a*. For the purposes of this Act, a deposit is,

*(a)* money deposited with a loan corporation or trust company registered under *The Loan and Trust Corporations Act* in respect of which such corporation or company is liable to the depositors; or

*(b)* money received under section 82 of *The Loan and Trust Corporations Act* by a trust company registered under that Act or a debenture or like obligation issued by a loan corporation registered under that Act, but not including any money so received or debenture or like obligation so issued on or after the 17th day of April, 1967, unless the trust company or loan corporation, as the case may be, is obligated, or may by demand of the

> depositor become obligated, to repay the money so received or the debenture or like obligation so issued on or before the fifth anniversary of the date of receipt of such money or the fifth anniversary of the date of issue of such debenture or like obligation, as the case may be.

For an annual premium amounting to the greater of $500 or one-thirtieth of 1% of the total deposits held by a "member institution" the Canada Deposit Insurance Corporation insures each deposit, except one not payable in Canada or in Canadian currency, one in respect to which her Majesty in right of Canada would be a preferred claimant, and so much of any one deposit as exceeds $20,000. The Ontario Deposit Insurance Corporation insures all deposits with a member institution not holding a policy issued by the Canada Deposit Insurance Corporation, except one not payable in Canada or in Canadian currency, or so much of any one deposit including interest as exceeds $20,000 and in respect of which insurance of the Canada Deposit Insurance Corporation has been terminated or cancelled, but it continued in force during a prescribed period of grace; the annual premium is calculated in the same manner. Very considerable powers of inspection and supervision are given by the federal act to the Inspector-General of Banks in connection with those institutions, and the Superintendent of Insurance in connection with loan and trust companies; in respect of provincial institutions the practice has been for the Canada Deposit Insurance Corporation to delegate these responsibilities to the Registrar of Loan and Trust Corporations in Ontario. The statutes must of course speak for themselves, but it would appear that a provincial institution can voluntarily terminate a policy of deposit insurance of the federal corporation, or is subject to cancellation by it if it is found to be "following unsound business or financial practices", or "is in breach of any by-laws of the Corporation applicable thereto" and fails to provide satisfactory remedies; previously insured deposits continue to be insured for a period of two years or "in the case of a term deposit with the remaining term exceeding two years, to the maturity thereof".

The sanctions bestowed upon these Crown corporations are impressive; even though the federal corporation may have cancelled insurance of the deposits of any member institution, if it is of the opinion that such institution is, or is about to become insolvent, it "may for the protection of the public interest, initiate and take any measures or proceedings that a creditor of the member institution may initiate or take under law to preserve the assets of the member institution, to have it wound up or to petition for a receiving order under the Bankruptcy Act". By section 33 of the Ontario Act the Ontario corporation has even more sweeping powers.

33.—(1) Where the Registrar has reported to the Corporation that, in his opinion, the affairs of a member institution are not in a satisfactory financial condition and the Corporation has reported that, in its opinion, the affairs of the member institution are not in a satisfactory financial condition and where the Minister, after a reasonable time has been given to the member institution to be heard by him and upon such further inquiry and investigation as he sees fit to make, reports to the Lieutenant Governor in Council that he agrees with the opinions of the Registrar and of the Corporation, the Lieutenant Governor in Council may, if he also agrees with the opinions, order the Corporation forthwith to take possession of the property of the member institution and to conduct the business thereof and to take such steps as in its opinion may be taken toward the removal of the causes and conditions which have made such proceedings necessary.

(2) The Corporation shall thereupon take possession of the property of such member institution and conduct its business and take such steps as in the Corporation's opinion may be taken toward the removal of the causes and conditions which have made such proceedings necessary, and for such purposes and without limiting the generality of the foregoing,

*(a)* the Corporation shall have all the powers of the board of directors of the member institution;

*(b)* the Corporation shall have power to exclude the member institution and its servants and agents from the property and business of the member institution; and

*(c)* the Corporation shall have power to carry on, manage and conduct the operations of the member institution and in the name of the member institution to preserve, maintain, realize, dispose of and add to the property of the member institution, to receive the incomes and revenues of the member institution and to exercise all the powers of the member institution.

(3) Upon the request of a member institution and with the approval of the Lieutenant Governor in Council, the Corporation may with respect to such member institution exercise the powers mentioned in subsection 2.

Under section 34, if the Ontario corporation considers that further efforts at rehabilitation would be futile, or that its affairs have been placed in a satisfactory financial condition, it may return possession of the member institution's property to it, and under section 35 there is provided a right of appeal to a judge of the Court of Appeal from an order made under the first subsection of section 33.

The duties of the Registrar, in compiling his report to the Ontario corporation referred to in section 33 of the Ontario Act, are set out in sections 30 and 31, and require examination.

30. The Registrar shall, on behalf of the Corporation, examine the affairs of each member institution at such times as the Corporation may require but no less frequently than once in each year.

To this were added subsections 2 and 3 by the amending act of April 1967, although there is no provision therein for numbering the existing content of section 30 as subsection 1.

> (2) The Registrar, at the request of the Canada Deposit Insurance Corporation and on such terms and conditions as may be approved by the Minister, may examine the affairs of any loan corporation or trust company registered under *The Loan and Trust Corporations Act* and report thereon to the Canada Deposit Insurance Corporation.
>
> (3) In any examination authorized under subsection 2, the Registrar has and may exercise any of the powers given him by subsections 3, 4 and 5 of section 117 of *The Loan and Trust Corporations Act.*

It will be seen that the Registrar thus has two authorities, one federal, the other provincial, in the shape of Crown corporations interposed between him and the minister to whom he is responsible. The nature of his report is remarkable and is contained in the next section.

> 31.—(1) After each examination of the affairs of a member institution, the Registrar shall report to the Corporation whether or not, in his opinion, there has been any change in the circumstances of the member institution that might materially affect the position of the Corporation as an insurer and particularly, without limiting the generality of the foregoing, whether or not, in his opinion.
>
> *(a)* the returns made by the member institution and on which payment of its premiums were based are correct;
>
> *(b)* the operations of the member institution are being conducted in accordance with sound business and financial practices; and
>
> *(c)* the member institution is in a satisfactory financial condition.
>
> (2) Each such report shall further state whether or not, in the opinion of the Registrar, there has been any breach of the provisions of *The Loan and Trust Corporations Act* and in particular, without limiting the generality of the foregoing whether or not, in his opinion, there has been any breach of the provisions of *The Loan and Trust Corporations Act* with respect to
>
> *(a)* borrowing powers;
>
> *(b)* reserves required on deposit under sections 74 and 84 of that Act; and
>
> *(c)* investments authorized by that Act.

By section 32, where the Ontario corporation's opinion (be it noted, "whether such opinion is based upon consideration of a report from the Registrar or upon any other report or information") is that a member institution is, or may be following unsound business or financial practices, or is not, or may not be in a satisfactory financial condition, or is, or may be in breach of either the Ontario Deposit Insurance Act or the Loan and Trust Corporations Act, it is bound to report in writing its views to the president or chairman of its board of directors, and he in

turn is bound to present that report to a meeting of these directors and incorporate the report in its minutes; the corporation also sends its report to the Minister. It will be observed that implicit faith is not here reposed in the provisions of the Loan and Trust Corporations Act. What the function of the Ontario corporation will be after the great bulk of the business it was supposed to transact has been undertaken by the Canada corporation is not clear, but these statutory provisions, which are matched by those at the disposal of the federal authority, evidently subject loan and trust companies carrying on business in Ontario to a new type of regulation, the administrators of which are invested with powers so generally worded as to be, in practice, absolutely discretionary and without whose approval they would be unable to do business, because it is not to be supposed that termination or cancellation of deposit insurance would not inevitably be followed by a run on deposits which would close their doors.

Such is the formidable accretion to the already heavy load of regulation borne by the trust companies carrying on business in Ontario, and for which the difficulties of British Mortgage & Trust Company and York Trust & Savings Corporation, both of which were saved from insolvency, first, by the government of Ontario and, second, by subordination to other companies which were induced to come to their assistance, must be considered entirely responsible. The rosy picture of the industry painted in 1964 by the Royal Commission on Banking and Finance, popularly known as the Porter Commission, which remarked its freedom from take-over and amalgamation since 1950, has taken on sombre hues, and in recent months, for one reason or another, independent trust companies of long standing and with imposing assets have lost their identity in a renewal of this process. This is partly due to the increasing competition provided by the chartered banks which benefited from two recommendations made by the Porter Commission, being relieved from the limitation on the rate of interest receivable on their loans, and allowed to enter the conventional mortgage investment field, recommendations which the Commissioners might not have made had they known that their proposals to enlarge the horizons of trust companies and other intermediaries would not be adopted. The Commissioners regarded most of the limitations contained in loan and trust company legislation as artificial and unnecessary, but excepted the limitation on the amount of individual mortgage loans which they thought should be increased from 66.6% to 75% of the value of the security, a recommendation now generally adopted. In short they placed much emphasis on disclosure and inspection, and decried the rigid ratios to which loan and trust companies have been subject hitherto. They did not contemplate the combination of these with the type of supervision imposed by the experiment in deposit insurance, but it is permissible to suggest that they would have discountenanced their co-existence.

**Proposals for Legislation in Ontario**

No examination of the question of what proper regulatory legislation for trust companies should be would be helpful without some reference to the striking position taken by the Porter Commission in the report which it issued in 1964.[1] Two paragraphs, occurring at the beginning of the chapter entitled "An Approach to Banking Legislation", are equally applicable to the problem of regulating the business of finance companies and loan and trust companies.

> "We have explained in earlier chapters that no regulatory framework can protect the investor in financial assets from losses if he is determined to speculate or if he does not investigate the financial position or reputation of the institutions with which he plans to deal. Nor can regulation guarantee that there will never be incompetent, negligent, or even dishonest management in the financial system, unless every transaction were to be investigated ahead of time and our economic life brought to a complete halt. Nevertheless, we believe the case for appropriate regulation of financial and banking institutions is not now in dispute; the workings of the financial system are complex and not always understood by its customers, and the handling of the public's funds for more or less prolonged periods of time opens possibilities of serious abuse in an unregulated system.
>
> At the same time, we have indicated throughout the report that an effectively executed and well-designed system of regulation need not lead to excessively rigid and detailed procedures which increase the costs and reduce the efficiency and flexibility of the financial system. In our view, the goal of protecting the public against loss can best be achieved with three basic legislative safeguards—adequate disclosure, competent supervision, and legal powers giving the authorities the right to force the correction of unsound or careless practices and to prosecute those engaged in fraudulent or criminal activities. Complete and continuing disclosure of the affairs of institutions should enable the public without unreasonable cost and inconvenience to obtain the necessary information about the reputation and strength of any financial concern, while competent and frequent self-regulation under the ultimate supervision and inspection of government is the best safeguard against an institution becoming insolvent although—of course—not a guarantee that it will not do so."

Later on, after referring specifically to the peculiar requirements of banking legislation, the Commissioners say:[2]

> "We are, however, convinced that excessive use of asset ratios and investment rules adds little to the protection of the public and can have serious effects on the adaptability and competitiveness of the financial systems. We therefore think it unwise to rely heavily on them."

[1]Report of the Royal Commission on Banking and Finance 1964, Queen's Printer, Ottawa; Chapter 18, p. 357.
[2]p. 358.

They went on, as is well known, to develop a far-reaching proposal for putting the chartered banks and what they refer to as "short-term intermediaries", or those who issued obligations repayable on demand or within 100 days, into one category of banking institutions under a revised Bank Act. The institutions not normally classified as banks would include Quebec Savings Banks, trust companies, mortgage loan companies and other deposit-taking companies, finance companies, the central societies of credit unions and *caisses populaires*, which fall under the definition of short-term intermediaries. For reasons which it is not appropriate for me to comment on, but which go to the very roots of the constitutional division of powers in this country, this proposal, which also required the maintenance of a cash reserve with the Bank of Canada by all these institutions, based on percentages of the deposits which they held amounting to 8% of their demand deposits and 4% of their term deposits, has not been implemented. One of the reasons, which has no constitutional significance, is that, although the chartered banks were anxious to secure the power to invest in conventional mortgages and have since, under the provisions of the new Bank Act, succeeded in doing so, some of the "near-banks", and in particular the trust companies, have not been anxious to enter the lending fields occupied by the chartered banks as was recommended, preferring, indeed, to develop the fiduciary business which gives them their unique quality. The arguments in favour of this preference are strong and convincing, particularly in the case of those trust companies which have concentrated on the expansion of administering assets under the head of estates, trusts and agencies; yet, when this has been said, there can be little quarrel with the general approach of the Porter Commission to the problem of regulation and the type of legislation which good regulation requires.

The submission of the Trust Companies Association,[3] which in great part consists of a memorial to the Quebec Study Committee on Financial Institutions dated November 18, 1966, incorporated therein because of its pertinence in October 1967, gives figures which suggest that a large amount of trust company business in this country is done in Quebec, but makes clear the fact that the figures are affected by those attributable to two of the giants of the industry—the Royal Trust Company and the Montreal Trust Company—which were incorporated in that province. These two companies, however, do business all over Canada, and to a large extent in Ontario, and it will be seen in appendix A to the Association's submission that all but one of the federally incorporated companies which are members have their head offices in Ontario, operating 181 branches as compared with the 170 branches of the member companies actually incorporated in this province. It has

[3]Appendix P.

not been considered necessary to bring these figures up to date, or to reflect recent mergers such as that of Canada Permanent Trust Company and Eastern & Chartered Trust Company, both of which were themselves amalgamated corporations. The Commission is advised that the desirability of doing business in Ontario is such that the Ontario Loan and Trust Corporations Act and the province's regulatory apparatus have a more general application than those of any other jurisdiction, since all corporations doing business in Ontario must be registered under the Ontario statute. It is therefore reasonable to believe that any revision of Ontario legislation will have an effect felt beyond provincial boundaries, as has been the case in the past.

I have said before that I think it would be advantageous, as well as conforming to the practice prevailing in other jurisdictions, to have separate statutes for loan companies and trust companies since the present Act has become unnecessarily complicated because of its application to both. The outstanding example of this is provided by section 137, expressed to apply to "loan corporations", but important parts of which are made applicable to trust companies by the operation of section 139. There are many others, and the wording of sections must be carefully watched for distinctions between "corporations", "registered corporations" and "provincial corporations" which would logically apply to both types of company, though not necessarily to all of them in both categories. As one might expect, the word "corporation", generally speaking, applies to every type of corporation to which the Act is applicable, but in sections dealing with loan corporations, such as section 75, the word "corporation", standing alone, would appear to refer only to them. An incorporated company is doubtless a corporation, but the act which is entitled "The Loan and Trust Corporations Act" never refers to "trust corporations" but only to "trust companies". This sort of confusion is not of great consequence and perhaps represents, as has been suggested before, the slow retreat of native modes of expression before the latest American fashions; nevertheless it is irritating and imprecise. The recommendations which I shall make here will, because of the preoccupation of this report with the affairs of British Mortgage & Trust Company and the legislation applicable to it, apply to trust companies on the assumption that a new act will be drawn applicable to them alone, but will not exclude the possibility of their applying to loan companies where they are appropriate.

Two significant points have emerged from the evidence given before this Commission dealing with the affairs of British Mortgage & Trust. The first is that the Registrar of Loan and Trust Corporations did not consider the limitations and restrictions imposed upon companies by the Act as necessarily excluding his own interpretation of them, and the second that, although W. P. Gregory was quick to take advantage of the precise operative effect of words in the Act when they suited his

arguments, they were not effective to prevent breaches of prescribed ratios when he had made up his mind to make them. In the case of the first, it is well established that the Registrar for many years has exercised what was generally conceded to be his right to make "rulings" about the acceptable meaning of words in the Act, as opposed to their plain meaning, or the meaning which would probably have attached to them if submitted to interpretation by the courts. For example, I am informed that section 82*a* prescribing the limitation on the "borrowing" powers of trust companies, enacted in 1965 but never proclaimed, is none the less being applied by the Registrar with the concurrence of all concerned. In the case of the second point, it must be considered doubtful that the words of any statute, however carefully drawn and applied by the regulatory authorities, can really be effective against a determined effort to circumvent their effect. The practice, observed so often in the case of British Mortgage & Trust, of transgressing limitations frequently and deliberately, and then restoring the situation to its lawful limits just before the date of the annual statement submitted to the Registrar, was not an invention of that company's president. Nevertheless, the trust companies carrying on business in Ontario have customarily shown a high degree of responsibility and capacity for self-regulation, and their willingness to abide by suggestions made by the Registrar as to the amount and quality of investments, made from time to time, is a pervasive fact. The expression "gentleman's agreement" has been used by former Registrars to describe their understandings with the heads of companies in the implementation of policy, or varying a strict interpretation of provisions of the Act. There is no reason to change the spirit of this relationship because of a few exceptional cases, one of which has been the subject of close examination by this Commission. It is unlikely that long-established companies, standing for prudence and reliability in the world of finance, will jeopardize their reputations, if their legitimate aims are supported by knowledgeable and flexible government regulation, designed at once to encourage the industry and protect the public. I say with deliberation, after long contemplation of the sorry performance of Atlantic Acceptance Corporation and British Mortgage & Trust Company, that it is unwise and short-sighted to construct legislation based upon experience with one or two backsliders, and with a view to protecting the public from what really amounts to a breach of faith, or of the law, which prescribed sanctions, if resolutely applied, are able to deter or punish. Therefore I propose, in the following recommendations, to place less emphasis on artificial limitations and restrictive ratios than is placed at present, and more upon disclosure of information, flexible regulation, and the prompt enforcement of sanctions as occasion requires.

The principle of public need recognized by section 17 of the Loan and Trust Corporations Act, governing the application for and grant of

incorporation as a trust company, should not be disturbed. For the reasons indicated in discussing incorporation of finance companies, the incorporation of a trust company is of sufficient moment to require the most careful scrutiny by the executive branch of the government.

## RECOMMENDATION XII

1. *Trust companies in Ontario should continue to be incorporated by letters patent issued under the Great Seal, upon petition to the Lieutenant Governor in Council and after consideration of a report by the Registrar on the sufficiency of the proposed by-laws of the company, its ability to provide service to the public, and the need therefor, and compliance with the requirements of the Act as to subscription for stock having been received amounting in the aggregate to the minimum amount required by law.*

2. *The provisions of the Loan and Trust Corporations Act relating to registration and admission to registry of companies incorporated in Ontario, or under the laws of Canada or any of its provinces, or under the laws of any other country, should be retained, except that where the approval of the Minister is now required the approval of the Lieutenant Governor in Council should be substituted.*

I pass over the sections dealing with election of directors and shareholders' meetings and by-laws, with the observation that they may require amendment in detail but no substantial change. The same may be said about the provisions of the Act dealing with shares, calls on capital stock, the increase or decrease of the latter and the provisions relating to a company's books. Those dealing with directors seem to be equally unexceptionable in principle but two observations should be made. The first arises from consideration of section 41 which is as follows:

> 41.—(1) Where the directors entertain reasonable doubts as to the legality of any claim to or upon any share, bond, debenture or obligation of the corporation, or to or upon any dividend, coupon or the proceeds thereof, they may apply to the Supreme Court, stating such doubt, for an order or judgment adjudicating upon such claim, and awarding such share, bond, debenture, obligation, dividend, coupon or proceeds to the person legally entitled to the same, and the court may restrain any action or proceeding against the corporation, or the directors or officers thereof, for the same subject-matter, pending the determination of the application.
>
> (2) If the order or judgment of the court is obeyed, the corporation and the directors and officers are fully protected and indemnified against all actions, claims and demands in respect of the matters in question in such application and the proceedings thereupon. R.S.O. 1960, c. 222, s. 41.

Here it would seem desirable that the application should in the first place be made to the Registrar with a right of appeal by all parties to the Supreme Court. The second arises from the necessity of protecting the directors of a trust company from the type of action contemplated by section 87 of the proposed Business Corporations Act 1968, as I have already suggested to be desirable in the case of another type of intermediary, the finance company. In the case contemplated by section 41, subsection 2 thereof gives the necessary protection. Generally speaking, however, the provisions of Recommendation X made with respect to finance companies[1] should be repeated in the case of trust companies, and for the same reasons stated with even greater emphasis, since the position of trust companies, fulfilling a purpose more closely associated with public need than that of the ordinary commercial company, and subject to greater scrutiny and regulation by government agencies, requires, first, the absolute protection of responsible directors, from vexatious legal proceedings, and second, the certainty that such proceedings, with their unpredictable result, should not be at cross-purposes with the policy of that regulation.

RECOMMENDATION XIII

1. *Where the directors of a trust company are in doubt as to the legality of any claim to or upon any share or obligation of the company, or to or upon any payment to be made in connection therewith, they should apply for adjudication thereon to the Registrar who should hear the representations of any interested party before giving his decision, from which an appeal may be taken by any director or interested party to the Supreme Court of Ontario; upon compliance with the decision of the Registrar or, on appeal, the order of the Court by the company, its directors and officers, no action shall lie against them in respect of any claim arising from the matter determined.*
2. *No action should be brought against any director or officer of a trust company to enforce any right, duty or obligation owed to his company only on the ground that an action taken or decision made by him was not in the best interests of the company, unless it is alleged that such action was taken or decision made fraudulently, negligently or in bad faith.*
3. *In any such action, notice, security for costs and costs should be in the discretion of the Court.*
4. *Indemnification by a trust company of a director or officer against whom such an action has been brought by a shareholder of such a company in a representative capacity on behalf of the company should be a question for its shareholders other than such director or officer.*

[1]p. 1625.

Sections 66 to 69, dealing with the audit and the statement to shareholders of a trust company, require amendment for reasons which have already been advanced in this chapter and in other chapters of this report. The amendments should recognize the desirability of the auditors expressing their opinion on the operating statement, or profit and loss account, particularly with a view to disclosing the movements of funds in and out of the general reserve, to restore the position which prevailed until 1960, and the importance of applying to trust companies the effect of sections 155 to 171 of the bill known as the Business Corporations Act 1968, dealing with auditors and financial statements, where appropriate. Not all the provisions of these sections are unexceptionable, and the Special Committee on Corporation Law of the Institute of Chartered Accountants of Ontario has made useful recommendations for their amendment. But, generally speaking, the provisions relating to the contents of financial statements, the duties of auditors and, above all, the establishment of an audit committee of a company's board of directors are wholly salutary, allowing auditors to discuss problems raised by the accounts with directors and shareholders, and freeing them from their previous dependence upon management and the internal accounting officers of the company for discussion of these problems. Here again my recommendations are not intended to be either comprehensive or exclusive, but merely suggest provisions which in my view should not be omitted from any new legislation dealing with trust companies.

## RECOMMENDATION XIV

1. *The directors of a trust company should be required to lay before the annual meeting of its shareholders financial statements for the financial year immediately preceding it, consisting of a balance sheet, a statement of income and expenditures and undivided profits and a statement of accumulated appropriations for losses or general reserve in a form prescribed either by regulations made as authorized by the Act or in any schedule thereto.*

2. *These statements should exhibit such figures relating to the financial position and operations of the company in, at least, the fiscal period immediately preceding the one under review by the annual general meeting as will provide the shareholders with a full comparison of them for both periods.*

3. *In their report the auditors of the company should state, with respect to each of the statements enumerated in 1, whether it presents fairly the financial position of the company, the results of its operations and the transactions in the reserve account, in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.*

4. *Where an auditor is unable or declines to express an opinion on any such statement in the terms set out in 2 above, he should state his reasons fully in his report.*
5. *An audit committee, consisting of not less than three directors of a company, the majority of whom should not be officers of or otherwise employed by the company, should review the company's financial statements before approval by the board of directors, and should confer with the auditors at any time at their own request, or at the request of any auditor.*

It has been seen that British Mortgage & Trust Company, although a trust company of long standing, conducted a business which was not very different from that of the average loan company, in that a large proportion of its assets consisted of mortgage loans and the amount of funds under administration was small compared with the average for the trust company industry; indeed its fiduciary activity was considerably below the average, and this fact may be attributed, first, to its location in a rural setting and, second, to W. P. Gregory's determination to increase assets and revenue as quickly as possible. It is well known that the variety of business conducted by trust companies is very great, and that some of the larger ones, with established connections in urban centres, have developed their fiduciary function to a point where assets under administration are predominant. Generally speaking, their investment in mortgages, although still the most important category among their assets, is much less in proportion to the whole than in the case of loan companies. On the other hand, trust companies, which are not permitted to "borrow" under the terms of the Loan and Trust Corporations Act, are more heavily dependent on the effective borrowing involved in accepting deposits and moneys for guaranteed investments than are the loan companies which may issue debentures; because deposits vary widely in term, many of them being repayable on demand, and guaranteed investment certificates are generally speaking confined to a maximum term of five years, with many being for a shorter term, trust companies are under some degree of handicap because of the statutory prohibition against borrowing money by issuing debentures. The difficulties inherent in "borrowing short and lending long" are consequently more likely to beset trust companies than loan companies, and it does not seem unreasonable to recognize the fact that trust companies do borrow, and to allow them to sell debentures as obligations subordinated to the claims of holders of guaranteed funds. Behind the latter, as provided for by section 80 in respect of deposits, and by section 82 in respect of funds for guaranteed investment, for both of which a trust company is deemed to be trustee, there must be "ear-marked and definitely set aside in respect thereof securities, or cash and securities, equal to the full aggregate amount thereof"; for this purpose cash includes moneys on deposit and

securities includes loans made upon securities. The maintenance of such a specific allocation, distinguishing a trust company from a loan company, should continue to be characteristic, and depositors and holders of guaranteed investment certificates should rank as creditors on the assets of a trust company ahead of the holders of its debentures.

There seems to be little justification for the imposition by statute of a limit upon the borrowing capacity of a trust company, and none at all if it is not allowed to issue debentures. The mechanism of the money market may be expected to impose limitations of its own on the ability of a company to issue debentures subordinated in such a way. Additional safeguards could be provided by making the issue of any debentures dependent upon the approval of its shareholders at a special general meeting, notice of which should be sent to the Registrar and at which he or his representative may attend and make representations. The limitations of the Trust Companies Act of Canada, and the duty of the Canada Deposit Insurance Corporation to insure the deposits of only those provincial member institutions which comply with provisions substantially in accordance with it, may in practice nullify the effect of any proposal to refrain from imposing limits on the growth or amount of guaranteed funds, but such a consideration should not be used to justify provincial legislation in the form of section 82*a* if it is not needed.

## RECOMMENDATION XV

1. *A trust company having paid-in unimpaired capital of at least $1,000,000 should have power to borrow money by issuing terminable debentures, provided that the provisions of subsection 2 of section 80 and subsection 3 of section 82 of the Loan and Trust Corporations Act, or others to the same effect, segregating and setting aside cash and securities to ensure repayment of deposits and money received for guaranteed investment respectively, continue in force, and that depositors and guaranteed investors rank ahead of holders of such debentures as creditors of the company in any claim upon its assets.*

2. *No such debentures should be issued unless approved beforehand at a general meeting of the company's shareholders to whom due notice of the question to be decided shall have been given, as well as to the Registrar who should be entitled to attend and be heard in person, or through a representative appointed by him.*

The liquidity provisions linked to this allocation of securities, originally for deposits only, by the application of section 84, and which the Porter Commission described as "meaningless", are now more precisely measured by the 1966 and 1968 amendments to that section, already noticed on page 1634, and the ratios there prescribed apply not only to

the aggregate of deposits, but to that of deposits and funds held for guaranteed investment as well. These provisions taken together, recognizing as they do the priority of depositors and guaranteed investors, and providing a minimum liquidity of assets for their protection, must also be considered in conjunction with those of the provincial and federal statutes dealing with deposit insurance and particularly the latter, section 16 of which has the following decisive content:

> 16. On the application of a provincial institution therefor, the Corporation may insure the deposits with the provincial institution in the manner and to the extent provided in this Act and the by-laws, if
>
> *(a)* the provincial institution is authorized by the province of its incorporation to apply for deposit insurance;
>
> *(b)* the provincial institution agrees, in carrying on its business, not to exercise powers substantially different from the powers exercisable by a trust company under the *Trust Companies Act* and a loan company under the *Loan Companies Act;* and
>
> *(c)* the Corporation approves the provincial institution for a policy of deposit insurance.

If, as appears likely, the trend of policy is toward a virtually compulsory insurance of deposits with the provincial institution by the Canada Deposit Insurance Corporation, it will be seen that, in the absence of amendment to paragraph *(b)* of this section, provisions of the Trust Companies Act of Canada will effectively displace those of the Loan and Trust Corporations Act of Ontario. The federal statute is at present undergoing extensive amendment by Bill S-37 read for the first time in the Senate of Canada on May 6, 1969. On the motion for second reading on May 8, the observations of the Honourable Paul Martin, government leader in the Senate, which are the most recent official comment on it available at the time of writing, were in part as follows:[1]

> The particular bill which stands in my name, Bill S-37, an act to amend the Trust Companies Act, proposes to effect certain amendments in the Trust Companies Act, an act which, as the house knows, governs the activities of federally incorporated trust companies in Canada. There are nine such companies presently active, and they transact close to one third of the trust company business in Canada.
>
> The principal purposes of the amendments are four in number. First, to provide certain expansion in the investment powers of trust companies; second, to establish a better and more flexible system of controlling companies that are in financial difficulty; third, to extend the prohibition against investments and loans where there may be a conflict of interest, and, finally, to establish a Letters Patent system of incorporating companies and amending existing charters.

[1]Debates of the Senate, 1st Session 28th Parliament Volume 117 No. 75 May 8, 1969.

Now, as to the investment powers, a number of changes are proposed, principally for the purpose of bringing the investment powers of trust companies into line with those of insurance companies as amended in 1965. Pursuant to these changes, trust companies would be permitted to make mortgage loans on the security of leasehold as well as freehold real estate; to make investments outside Canada, in any country in which they are doing business; to make investments in real estate for the production of income that qualifies on the basis of an earnings test, and to make investments in real estate for the production of income in larger parcels than is presently permitted.

They would also be enabled to invest or lend guaranteed trust funds at their own discretion up to a maximum of 7 per cent of the fund. This corresponds to the so-called "basket" provision available for life insurance companies. At present the power to make mortgage loans is subject to a restriction that the amount of any mortgage cannot exceed 75 per cent of the value of the real estate unless the excess is insured through a Government agency. An amendment would permit mortgages to be made in excess of the 75 per cent limit, if the excess were insured through a policy of mortgage insurance issued by a registered insurance company. Other changes would effect an expansion of investment powers in minor respects, bringing them into line with the powers of insurance companies.

Trust companies would be granted authority to own subsidiary companies in certain circumstances, subject to terms and conditions specified by the Governor in Council. They would be empowered to own and operate, as subsidiaries, trust companies incorporated outside Canada, companies incorporated to establish and operate a mutual investment fund, mortgage loan companies, or companies engaged in any activity reasonably ancillary to that of a trust company.

The existing requirement for a minimum statutory margin on collateral loans would be removed and companies would be able to exercise their own discretion as respects the margin of collateral over the amount of the loan.

The existing prohibitions against making loans to officers or directors would be expanded to prohibit loans to or investments in any major shareholder and also loans to or investments in any other corporation, if a director, officer or major shareholder had a significant interest in that other corporation.

As respects the revisions in the system of supervision and control of companies, the present act enables the Minister to impose conditions or limitations in the licence of a company which is subject to annual renewal. The act also requires the Superintendent to report to the Minister, if he considers that the assets of the company are insufficient to justify its continuation in business, and the Minister has the authority to suspend or cancel the licence of the company. It is proposed that some flexibility be introduced to give certain stages of control short of actual cancellation of the licence. The proposals are similar to those included in the Canadian and British Insurance Companies Act. They would require the Superintendent to report to the Minister when he

considers that a company is in weak financial condition, where it has exceeded its borrowing powers or where the assets in Canada are not sufficient to cover the liabilities in Canada. The Minister could then take one or more of three steps: he could impose conditions in the company's licence; he could prescribe a time within which the company is to remedy the defect, or he could direct the Superintendent to take control of the company's assets.

In any case, where the Superintendent has control of a company's assets, the Minister may request the Attorney General to apply to a superior court for an order to require the Superintendent to take control of a company for its rehabilitation, or he may request the Attorney General to apply for a court order to wind up the company under the Winding-Up Act. The Superintendent would be empowered to assess other trust companies for the expenses involved in control of a company by him.

As further steps in the pattern of improved supervision and reporting, trust companies would be required to file quarterly statements to permit up-to-date information to be gathered as to their liquidity position, and also semi-annual statements showing the changes in investments and loans. A provision would be inserted requiring companies to maintain a liquidity reserve equal to 20 per cent of the guaranteed funds repayable on demand or repayable within 100 days. This reserve would have to be in the form of federal or provincial bonds or cash.

At present, trust companies are limited to accepting guaranteed trust funds that do not exceed in total 15 times their capital and surplus. The amendments would propose that this limit be raised to 20 times, subject to approval by the Minister on specific application by a company.

At the present time new federal trust companies may be incorporated only by special Act of Parliament, and charters of existing companies can be amended only by an amending Act. The amendments proposed would establish a new system of incorporating companies and amending existing charters. This would be by letters patent issued by the Corporations Branch of the Department of Consumer and Corporate Affairs, subject to the concurrence of the Minister of Finance. It is contemplated that in any application for a new charter the Superintendent of Insurance would investigate the matter just as he does now, and notice would be required in the *Canada Gazette* similar to the notice now required for the introduction of a private bill. Existing charters, even those granted by special Act of Parliament, could be amended by letters patent in accordance with the proposals in the bill, and provincial companies seeking to change their status to that of a federally incorporated company would be enabled to do so pursuant to letters patent continuing the company as a federal company. The grant of letters patent for this purpose would be subject to the concurrence of the province of incorporation and to the enactment of appropriate provincial legislation, where required. These changes would simplify the system of granting charters and amendments to existing charters. This would relieve Parliament from the application of time expended in consideration of these problems.

A standard form of letters patent would be used but there would be enough flexibility to provide for special situations. Charters could contain or could be amended to contain limits on voting rights or on share ownership, if desired by the incorporators or the shareholders.

At the present time the initial capital for any new company is specified in its private bill and is considered by Parliament on an individual basis. The proposed change in the system of incorporation also specifies that before a company may be authorized to commence business it must have a minimum capital of at least $1 million.

The proposals concerning the change in method of incorporation are similar to those proposed for insurance companies and mortgage loan companies.

A number of other amendments of somewhat lesser importance are proposed. Many of these are changes in wording or changes for the purpose of altering an administrative procedure. Some of the principal items dealt with are a requirement that notice of any major transfer of stock be given to the Superintendent of Insurance at least thirty days before the transfer is to be effected, together with full information concerning beneficial ownership. This would be required in respect of the transfer of a block of stock in excess of 10 per cent of the total and in the case of a transfer that would have the effect of changing control of the company. This would not constitute a veto power in the hands of the Superintendent or the Government but would require full disclosure and prior notice.

An amendment would limit the maximum age of eligibility to be elected as a director to 75 years with effect from 1972. This change parallels the change that was made in the Bank Act a few years ago. Three-quarters of the directors of a company would be required to be Canadian citizens resident in Canada rather than only a majority as at present. This also parallels the Bank Act. The existing provision enabling a company to issue share warrants would be repealed. Share warrants in this sense refer to a certificate issued by the company enabling the holder to demand certain shares of stock from the company. It is not the same as a share purchase warrant as commonly used in references to security markets at the present time. No company issues these share warrants now, and it is considered that the practice would be such as to defeat the provisions in the act limiting the non-resident ownership of shares. Some amendments are proposed with respect to the limitations on non-resident ownership for the purpose of clarification and for the purpose of specifying that voting rights of non-residents are preserved if they were acquired at a time when a company was exempt from the restrictions.

Some changes are proposed in the requirements concerning auditing. These will specify the qualifications of an auditor to bring these into line with the requirements of the Bank Act, and the Superintendent will be given power to expand the scope of the audit if he thought this action was necessary.

A number of other less important amendments effecting, principally, changes in wording are also proposed.

> Honourable senators will find the bill perhaps more extensive than the amendments I have described would appear to indicate, particularly in regard to investment powers. This arises because under the Trust Companies Act investment and lending powers are dealt with in three separate places. The first deals with unguaranteed trust funds, the second with guaranteed trust funds, and the third with a company's own funds, that is, its capital, surplus and retained earnings.
>
> Changes are proposed to transfer certain responsibilities from Treasury Board to the Minister in recognition of changes in the organization of government departments. This is in line with the two previous measures.
>
> It is recommended that the bill be considered by the Committee on Banking, Trade and Commerce and the amendments can there be considered in detail with the help of technical witnesses."

An analysis of this bill will not be attempted since it has not, at the time of writing, been enacted, but it seems clear that the practical effect of the deposit insurance legislation, on the assumption that companies will be encouraged by the Province of Ontario to seek insurance from the Canada Deposit Insurance Corporation, will be to compel compliance with the provisions of the Trust Companies Act of Canada as amended from time to time. Such an assumption may none the less be falsified by statutory amendment at any point, and it is perhaps only necessary to refer to the current situation to draw attention to the difficulties confronting any one who seeks to make detailed recommendations for amendment of the Loan and Trust Corporations Act. I must proceed, therefore, with general observations which I hope may be considered with due regard for the fact that proposed legislation and the studies and recommendations of many bodies are now, all at once, converging upon the same subject.

With the position of depositors of less than $20,000 and holders of guaranteed investment certificates payable in less than five years now abundantly secured, the question arises as to how much of the intricate network of limitations on trust company investments should still be retained. The answer should be, both in the interests of the economy and of the trust companies themselves, as little as possible. Trust companies, as already observed, have shown a capacity for self-regulation commensurate with their importance in the financial community, and this, taken together with the overwhelming powers of regulation now vested in the Registrar under the Loan and Trust Corporations Act as amended, and as agent for the Canada Deposit Insurance Corporation, not to mention those conferred by the Ontario Deposit Insurance Corporation Act, assure the public of a wide margin of safety in their operations. The limitations contained in, or incorporated by reference to section 139 of the Loan and Trust Corporations

Act can therefore be sensibly relaxed, and trust companies allowed to invest more as they please in the certain knowledge that they will, in all doubtful situations, have to invest as they are told. Their important function as executors, trustees and agents administering assets would not be affected by such a relaxation of statutory limitation, since the separate instruments under which this is discharged, either by operation of the Trustee Act or by their own terms, are self-regulating; in the case of estates and trusts the provisions of section 78, governing the employment of a "common trust fund", provide additional protection. Limitations may usefully be retained in the shape of those prescribing the maximum of 75% of the value of improved real estate which may be advanced by way of mortgage, the margin of safety for collateral loans, the minimum investment of 50% of a company's own funds, and funds received as deposits or for guaranteed investments, to be invested in securities permitted by the Trustee Act as provided in subsection 1 of section 139, the substance of the liquidity provisions of section 84, and the provisions of section 142 regulating concentration of investment in the securities of any one company and companies associated with it. Here again recognition should be given to the proposed amendment to the Trust Companies Act of Canada allowing a mortgage investment in excess of 75% of the value of the property by which it is secured, provided that the repayment of such excess is insured by a registered insurance company.

RECOMMENDATION XVI

1. *A trust company should confine its investments in real estate to such as are required for its own purposes in the opinion of the Registrar, or as authorized by the Lieutenant Governor in Council, and, for the purpose of producing income only, to "improved real estate" as defined by statute.*

2. *The amount of money invested by a trust company in any mortgage of improved real estate or leaseholds, together with the amount of indebtedness secured by any other mortgage of the same property not subordinate to it, should not exceed 75% of the value of the real estate or leasehold, unless repayment of the excess of the investment over that amount is insured with a registered insurance company.*

3. *A trust company should only lend money on the security of bonds, debentures, notes, stocks or other securities of any company or bank having an established market value approved by the Registrar, and only when that market value exceeds the amount of the loan for which such securities are pledged by at least 20% of their market value at all times, provided that the amount lent on the security of the stocks of any such company or bank does not at any time exceed*

*10% of the established market value of the total outstanding stocks of such company or bank.*

4. *A trust company should at all times keep invested at least 50% of money received as deposits, or for guaranteed investment, in such securities as are authorized by the Trustee Act.*
5. *To facilitate the payment of claims by depositors and the holders of guaranteed investment certificates, a trust company should maintain, to the value of not less than 20% of the amount of deposits, and of funds received for guaranteed investment coming due in less than 100 days, cash and lines of credit from chartered banks in Canada, and such investments in securities maturing in 10 years or less, as may be approved by the Registrar.*
6. *Except as to securities issued or guaranteed by the Government of Canada, or of any province of Canada, or by any municipal corporation in Ontario or city in Canada, and in the paid-up capital stock of any company control of which is permitted to it either by statute or by leave of the Lieutenant Governor in Council, a trust company should not invest any of its own funds or money received as deposits or for guaranteed investment in any one company or bank, by way of purchasing stock or other securities or lending on the security of debentures, mortgages or other assets or any part of them, an amount exceeding 15% of its own paid-in capital stock, plus its unallocated reserve funds as determined annually by the Registrar.*

The regulatory powers conferred upon the Registrar by the Loan and Trust Corporations Act of Ontario, now already very considerable, must, with the appearance of deposit insurance, be inevitably enhanced. It is to be hoped that the staffing problems of his department, which were manifest in the days when my investigation began, have now been resolved, as to numbers and qualification, in terms commensurate with his heavy responsibilities both as Registrar and Superintendent of Insurance. The multiplication of numbers in any government department is not, as I shall have occasion to repeat, a necessary measure of efficiency in supervision and enforcement, and the Registrar should not be inhibited in any way from calling upon lawyers and chartered accountants outside his department for assistance when unusual pressure of work makes it desirable. Although the ultimate sanction at his disposal is the removal of an offending company from the register—an action which would automatically close its doors—the Registrar should have the means of preventing so drastic a step and should not himself be expected to take it. Removal from the register or cancellation of a licence, whatever the form prohibition may take, is, like the creation of a trust company, the proper concern of the responsible minister, acting, of course, after considering the advice of the Registrar and, in turn,

advising the Executive Council with which the ultimate responsibility should lie. Generally speaking, the Registrar should be in a position to require, as he now would appear to be able to do under the Act as it stands, any information which he considers to be pertinent to his own responsibilities, either as prescribed in the quarterly and annual statements, or as supplementary to them. To this I would add copies of the minutes of the board of directors of a trust company, together with minutes of any committee of the board to be furnished forthwith after they have been signed, so that he and his inspectors would, between inspections, have current knowledge of a trust company's recorded transactions. On the other hand, the directors of a trust company should also be furnished with copies of correspondence between the Registrar and his staff and the company's officers on all questions relating to compliance with the Act and rulings of the Registrar, and should individually certify in the annual statement made to the Registrar that, during the course of the year to which the annual statement applies, no breaches by the company of any provision of the Act or ruling of the Registrar have come to their attention, if such be the case, or the nature and extent of such breaches as may have come to their attention if it is not. A statement to the same effect should, of course, be furnished by the auditors, in addition to what is now required under section 152.

The conferring of important new powers on the Minister of Consumer and Corporate Affairs and the Superintendent of Insurance at Ottawa has been proposed by the Senate's Bill S-37 to amend the Trust Companies Act of Canada. They appear as a new section 74 and additional sections 74A and 74B, replacing the existing section 74 which authorized a more leisurely procedure.

> 74. Where it comes to the attention of the Superintendent, by any means whatever, that any assets that appear on the books or records of a trust company or any assets held in trust by or under the administration of the company may not be satisfactorily accounted for and upon investigation the Superintendent believes that any of those assets are not satisfactorily accounted for and that all the circumstances so warrant, he may immediately take control of the assets of the company, the assets held in trust by the company and all other assets under its administration and may maintain such control on his own initiative for a period of seven days and with the concurrence of the Minister for any longer period that the Minister considers necessary in the circumstances.
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> 74A. (1) The Superintendent shall report to the Minister in any case where the Superintendent is of the opinion that
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> *(a)* the company is in violation of subsection (3), (4) or (5) of section 70;
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> *(b)* the assets of a company are not sufficient, having regard for all the circumstances, to give adequate protection to persons who have

entrusted money to the company for investment, the repayment of which is guaranteed by the company, and to creditors of the company; or

*(c)* the guaranteed trust funds of the company in Canada are less than the total amount of money accepted in Canada in trust for investment, the repayment of which is guaranteed.

(2) Where the Minister, after full consideration of the matter and after a reasonable time has been given to the company to be heard, believes that the situation described in any paragraph of subsection (1) exists, the Minister may take one or more of the following actions:

*(a)* he may make the company's licence subject to such limitations or conditions as he considers appropriate;

*(b)* he may prescribe a time within which the company shall correct the violation described in paragraph *(a)* of subsection (1) or make good the deficiency or inadequacy of assets described in paragraph *(b)* or *(c)* of subsection (1); and

*(c)* he may direct the Superintendent to take control of the assets of the company, the assets held in trust by the company and all other assets under its administration.

(3) Upon the company's failure to correct a violation described in paragraph *(a)* of subsection (1) or make good any deficiency or inadequacy of assets described in paragraph *(b)* or *(c)* of subsection (1) within the time that may have been prescribed pursuant to paragraph *(b)* of subsection (2), or any extension thereof subsequently given by the Minister, the Minister shall direct the Superintendent to take control of the assets of the company, the assets held in trust by the company and all other assets under its administration.

(4) For the purpose of carrying out the provisions of this section, the Minister may appoint such persons as he deems proper, to appraise and report on the condition of the company and its ability, or otherwise, to meet its obligations and guarantees.

74B. (1) Where the Superintendent has control of the assets of a company pursuant to section 74 or 74A,

*(a)* the company shall not make any loan or any purchase, sale or exchange of securities or any disbursement or transfer of cash of any kind whatever without the prior approval of the Superintendent or a representative designated by him and a director, officer or employee of the company shall not have access to any cash or securities held by or in respect of the company unless he has with him a representative of the Superintendent or unless such access is previously authorized by the Superintendent or his representative; and

*(b)* expenses incurred by the Superintendent in such control of assets shall be included in the expenditure assessed against trust companies pursuant to section 8 of the *Department of Insurance Act.*

(2) Within any period during which the Superintendent has control of assets pursuant to section 74 or 74A the Minister may request the

Attorney General of Canada to apply to a superior court for an order directing the Superintendent forthwith to take control of the company for the purpose of its rehabilitation or the Minister may request the Attorney General of Canada to apply to a superior court for an order to wind up the company under the *Winding-up Act.*

(3) Where a court has, pursuant to subsection (2), issued an order directing the Superintendent to take control of the company for its rehabilitation,

*(a)* the Superintendent may appoint one or more persons to manage the company, and

*(b)* the remuneration of any person, other than an employee of the Department, appointed pursuant to paragraph *(a)* shall be fixed by the Minister and paid as an expense of the Department and that expense, together with any other expenses incurred by the Superintendent in exercising control of the company shall be included in the expenditure assessed against trust companies pursuant to section 8 of the *Department of Insurance Act.*

(4) At any time that the Minister believes that a company, in respect of which the Superintendent has control of assets pursuant to section 74 or 74A or control of the company for its rehabilitation pursuant to this section, meets all the requirements of this Act and it is otherwise proper for the company to resume control of its assets or the conduct of its business, the Minister may direct the Superintendent to relinquish control of the assets of the company or request the Attorney General of Canada to apply to a superior court for an order directing the Superintendent to reliquish control of the company.

(5) At any time that the Minister, on the report of the Superintendent, deems that further efforts to rehabilitate a company in respect of which the Superintendent has control pursuant to subsection (2) would be futile, he may request the Attorney General of Canada to apply to a superior court for an order to wind up the company under the *Winding-up Act.*

(6) The companies subject to share in expenses resulting from the control of assets of a company pursuant to subsection (1) or from control of a company pursuant to subsection (3) may appoint a committee of not more than six members to advise the Superintendent in respect of assets, management and all other matters pertinent to the duties and responsibilities of the Superintendent in exercising such control.

(7) In any case where the Superintendent relinquishes control of the assets of a company or control of a company pursuant to subsection (4), that company is liable for repayment of all expenses assessed against and paid by other companies pursuant to this section and such interest in respect thereof as may be approved by the Superintendent; but the other companies may, if there is unanimous consent, relieve the first-mentioned company of its liability in respect of expenses borne by those other companies, or any part of it, or any of those other companies may relieve

the first-mentioned company of its liability in respect of expenses borne by that other company, or any part of it.

(8) In any case of winding-up of a company pursuant to subsection (2) or (5), expenses assessed against and paid by other trust companies pursuant to this section, and such interest in respect thereof as may be approved by the Superintendent, constitute a claim against the assets of the company prior to any claim in respect of the shares of the company.

(9) No action lies against Her Majesty, the Superintendent or a representative of the Superintendent for anything done or omitted to be done in good faith by the Superintendent or his representative while the Superintendent has control of assets of a trust company pursuant to section 74 or 74A or control of a company pursuant to this section.

(10) Notwithstanding anything in this section, a company affected by this section may, at any time before a winding-up order is issued by the court, negotiate for the sale of the assets of the company and for the transfer of its liabilities to some other corporation under the provisions of section 80, or for the amalgamation of the company with some other company or companies pursuant to section 80A.

Section 70 of the Trust Companies Act is that which confers borrowing powers and sets a limit to "the aggregate of the sums of money borrowed and the sums of money entrusted to the company for investment repayment of which is guaranteed by the company" of no more than 12½ times the excess of the company's assets over its liabilities, a limitation which it is now proposed to increase to 20 times such aggregate amount. The scheme of these provisions apparently contemplates two situations; one where an isolated delinquency requires control of a company's assets by the Superintendent for a temporary period, and the other where an extensive review of its affairs and a more prolonged period of rehabilitation are required. Under section 118 of the Loan and Trust Corporations Act the analogous powers of the Registrar, the Minister and the Lieutenant Governor in Council are as follows:

118.-(1) If, as the result of the examination, the Registrar is of opinion that the assets of the corporation are insufficient to justify its continuance in business, he shall make a special report to the Minister on the condition of the corporation.

(2) If the Minister, after a reasonable time has been given to the corporation to be heard by him, and upon such further inquiry and investigation as he sees fit to make, reports to the Lieutenant Governor in Council that he agrees with the opinion of the Registrar, the Lieutenant Governor in Council may, if he also concurs in the opinion, suspend or cancel the registry of the corporation, and the corporation shall thereupon cease to transact further business, but the Minister may, during such suspension or cancellation, issue such conditional registry as he deems necessary for the protection of the public.

(3) If the Minister deems it advisable, the conditional registry may provide that the corporation shall, during the continuance of the conditional registry, arrange for the sale of its assets and for the transfer of its liabilities.

(4) If upon the expiration of the conditional registry no arrangement satisfactory to the Minister has been made for such sale and transfer, and if in the opinion of the Minister the corporation's condition is not then such as to warrant the restoration of the corporation's registry, the registration shall be cancelled. R.S.O. 1960, c. 222, s. 118.

Additional provision should be made for rehabilitating the affairs of a trust company under the circumstances contemplated by sections 74A and 74B of the federal bill, so that the Registrar's powers of superintendence and control, short of putting a company out of business of his own motion, will be strengthened.

RECOMMENDATION XVII

1. *In addition to the powers conferred upon the Registrar as to a special audit by section 114 of the Loan and Trust Corporations Act, he should be authorized to consult and employ such accountants, lawyers, and other professional advisers as the urgency of any particular case requires.*
2. *Suspension or cancellation of the right of a trust company to do business in Ontario, by removal of its name from registration under the Act or any other means, should be effected by Order-in-Council after consideration by the Minister of a report made by the Registrar.*
3. *Forthwith after the signature of the minutes of any meeting of the board of directors of a trust company, or of the minutes of any committee thereof, by the officers authorized to do so, certified copies should be furnished to the Registrar.*
4. *The annual statement of the affairs of a trust company supplied to the Registrar should be accompanied by certificates from each of the directors of the company and each of its auditors, certifying that no breach of any of the provisions of the Act, or of the rulings made thereupon from time to time by the Registrar, has come to their attention during the period to which such annual statement applies if such be the case, or setting out the nature and extent of such breaches as may have come to their attention during such period.*
5. *The Registrar may require that copies of correspondence between himself and officers of a trust company should be furnished to each member of the company's board of directors, and should take such steps as he considers necessary to see that this is done.*
6. *As a supplement to the provisions of section 118 of the Loan and Trust Corporations Act, the Minister should be empowered, upon*

*the report of the Registrar that a trust company's assets are not satisfactorily accounted for, or not sufficient to give adequate protection to persons who have advanced money to it by way of deposit or loan, or the operations of which have been in substantial and deliberate breach of prohibitions or limitations imposed by the Act, to direct the Registrar to take control of any or all of the company's assets for such period as he considers necessary to accomplish*

(a) *the reorganization of the company upon a basis consistent with the provisions of the Act, and the security of its depositors and holders of its guaranteed investment certificates, or*

(b) *the securing of an order by the Supreme Court of Ontario for the appointment of a receiver and manager of the company, or*

(c) *the cancellation of its registration after securing to the best of his ability the interests of its depositors, guaranteed investments, owners and beneficial owners of assets under its administration.*

7. *The Minister, the Registrar and such officers and agents as they may appoint for the purposes set out in 6, should not be liable, or, if liable, should be indemnified for any damages or costs incurred as a result of any claim made against them for any action taken by them in good faith while a company's assets are under the control of the Registrar.*

As has been said, the foregoing recommendations are not intended to be comprehensive in the sense that they pretend to deal with every aspect of the regulation of trust companies in Ontario; rather they consist of conclusions reached in the course of examining the problems of British Mortgage & Trust Company in the context of the Loan and Trust Corporations Act, as it stood in 1964 with amendments subsequently made, the introduction of deposit insurance legislation and current proposals, as far as they are able to be discerned, in the federal field. Moreover they suffer from being closely related to the structure of the Loan and Trust Corporations Act as it now exists, and necessarily so because it is not part of my task to design a complete revision of the statute, even if this Commission had the resources to do so. In short the Act, although full of provisions which reflect problems of an earlier day, has worked reasonably well because of a full measure of understanding and co-operation between the Registrar and the industry, and its weaknesses have only become apparent when this has not existed in isolated cases. This relationship should be the foundation of any new legislation, and should be fostered rather than discouraged by a multiplicity of statutory restrictions designed to deal with extreme and unlikely situations in a *milieu* where good sense and high principle are expected to prevail.

## General Observations on Investigation and Enforcement

This Commission was constituted under the Public Inquiries Act of Ontario[1] the first two sections of which are as follows:

> 1. Whenever the Lieutenant Governor in Council deems it expedient to cause inquiry to be made concerning any matter connected with or affecting the good government of Ontario or the conduct of any part of the public business thereof or of the administration of justice therein and such inquiry is not regulated by any special law, he may, by commission, appoint one or more persons to conduct such inquiry and may confer the power of summoning any person and requiring him to give evidence on oath and to produce such documents and things as the commissioner or commissioners deem requisite for the full investigation of the matters into which he or they are appointed to examine. R.S.O. 1950, c. 308, s.1.
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> 2. A commissioner has the same power to enforce the attendance of witnesses and to compel them to give evidence and produce documents and things as is vested in any court in civil cases. R.S.O. 1950, c. 308, s. 2.

It is clear that, although the commission is issued in Her Majesty's name and Royal Commissions in the past have been created by an act of the prerogative, in Ontario now, as in other parts of her dominions, their creation and conduct are governed by statute; in addition, the validity of a commission and of any decision of a commissioner, as well as his jurisdiction, are subject to review by the Court of Appeal as provided for in section 5.

> 5.-(1) Where the validity of the commission or the jurisdiction of a commissioner or the validity of any decision, order, direction or other act of a commissioner is called into question by any person affected, the commissioner, upon the request of such person, shall state a case in writing to the Court of Appeal setting forth the material facts and the decision of the court thereon is final and binding.
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> (2) If the commissioner refuses to state a case, any person affected may apply to the Court of Appeal for an order directing the commissioner to state a case.
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> (3) Pending the decision of the stated case, no further proceedings shall be taken by the commissioner.
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> (4) No action shall be brought or other proceeding taken with respect to anything done or sought to be done by the commissioner or to restrain or interfere with or otherwise direct or affect the conduct of any such commissioner. R.S.O. 1950, c. 308, s. 5.

This supervisory jurisdiction of the Court of Appeal has been generally exercised with an eye to the special character of the inquiry. Thus the

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[1] R.S.O. 1960, c. 323.

procedure laid down by Mr. Justice Arthur Kelly in the Royal Commission on Windfall Oil & Mines Limited to the effect that all witnesses would be examined in the first instance by counsel to the Commission, and that cross-examination of any witness by counsel for an affected party, against whom criminal conduct had been alleged, should be by leave of the Commissioner, was sustained by the Court in an unreported case stated by him, as was his decision that in the particular circumstances counsel for the affected party could not himself cross-examine, but must put questions through the mouth of Commission counsel. This was the procedure followed by myself, and I did permit counsel for Donald W. Reid to cross-examine the witnesses who had made allegations of criminal conduct against his client. The only case stated by me for consideration by the Court of Appeal was, as may be seen at Appendix C, concerned with another, albeit an important point. On a later occasion, when Mr. Justice W. D. Parker, conducting the Royal Commission to Investigate Allegations relating to Coroners' Inquests, stated a case involving the right of Commission counsel to lead the evidence, the Court (per Aylesworth J.A.) held that, since he was inquiring into specific allegations by Dr. M. P. Shulman, the latter should be permitted to adduce the evidence in support of them by his own counsel, and that he and the witnesses he called should be subject to cross-examination by counsel for the Commission.[2] Two aspects of section 5, one an anomaly and the other a source of real difficulty, may here be noticed, with the observation that, although they have been drawn to the attention of authority, it was decided not to amend them until the Royal Commission Inquiry into Civil Rights had reported. They were, first, the words in the first subsection indicating that a commissioner was bound to state a case to the Court of Appeal, when requested by any person affected, with the contradictory provision in the second subsection that he might refuse to do so, and, second, the provision in the third subsection that no further proceedings could be taken by the commissioner until the stated case had been decided. The latter provision, which imposed a month's delay on the proceedings of this Commission in the case stated by me and might, if more than one case had been stated, have had serious consequences, was in due course the subject of a recommendation for amendment by the Honourable J. C. McRuer in Report No. 1 of the Royal Commission Inquiry into Civil Rights, which, if implemented, will ensure that a commissioner is only prevented from proceeding in the matter which is the subject of the stated case itself.[3]

The former Chief Justice of the High Court has dealt at considerable length with the contents and the implications of the Public Inquiries Act, because so many Ontario statutes confer on public officials "the

[2](1967) 2 O.R. 375.

[3]Report of the Royal Commission Inquiry into Civil Rights, Report No. 1, Volume 1, p. 457; Queen's Printer, Toronto.

powers of a commissioner appointed under the Public Inquiries Act".[4] I shall not attempt to make any extensive comment on the recommendations in respect of the Act contained in his deservedly famous report, other than to express respectful agreement with all but one of them, and to make some supplementary comments of my own based on three and a half years' experience of operating under its provisions. The cardinal principles to be observed for investigations under it are fairness and flexibility. For instance, the problems of investigation and procedure presented by an inquiry into the affairs of Atlantic Acceptance Corporation and British Mortgage & Trust Company are of a different order from those confronting an inquiry into the conduct of a public official in an isolated case. This has been recognized by the Court of Appeal, and the thread that runs through all the decisions is that a commissioner should be allowed the greatest latitude of discretion consistent with observance of historic principles of law designed to protect the liberty of the subject. This should be recognized in any revision of the Public Inquiries Act, and in any attempt to specify the powers of the Court of Appeal in such a manner as the former Chief Justice suggests.[5] I am greatly indebted to the many counsel that appeared before this Commission for their high sense of duty and responsibility, not only in protecting the interests of their clients but in assisting me in the discharge of a laborious and complicated task; if for instance unrestricted right of cross-examination had been permitted under the Act, our proceedings would have been of necessity submerged by repetition and irrelevancy, particularly in circumstances where no discovery was available to define and narrow the issues for the assistance of counsel at a public hearing. The possibility of inappropriate rules being made applicable to investigations of this type comes perceptibly closer when one considers the provisions of a bill at present before the Legislature to enact the Statutory Powers Procedure Act 1968-9. This bill applies to tribunals defined by paragraph *(b)* of subsection 1 as follows:

> "tribunal" means one or more persons, whether or not incorporated and however described, who may exercise an administrative, quasi-judicial or judicial power conferred by the Legislature, whereby any right, duty or privilege of any person may be decided at or following a hearing, but does not include a court of record or a coroner's inquest.

It may not be intended to include an inquiry held under the Public Inquiries Act in this definition, but it should be observed that the proposed Statutory Powers Procedure Rules Committee, constituted by section 16 has, under section 19, authority, subject to the approval of the Lieutenant Governor in Council, to "make rules of practice and procedure applicable to . . . any inquiry held pursuant to *The Public Inquiries Act*".

[4] Ibid. Vol. 1 Appendix A.
[5] Ibid. p. 457.

The approval of the Lieutenant Governor in Council here required no doubt refers to the enactment of such rules by order-in-council as regulations under the Act, and the words "any inquiry" may well mean *all* inquiries. If such be the case there is real danger that the discretion of a commissioner as at present supervised by the Court of Appeal may be nullified by a rigid code of procedure.

One of the recommendations of the McRuer Report, which must be carefully considered in any revision of the Public Inquiries Act, is that "a section similar to section 13 of the Inquiries Act of Canada, but in more precise language, should be included in the Act".[6] Section 13 of the Inquiries Act[7] is as follows:

> 13. No report shall be made against any person until reasonable notice has been given to him of the charge of misconduct alleged against him and he has been allowed full opportunity to be heard in person or by counsel.

The learned Commissioner suggests,[8] in view of the difficulties which this section has caused, that if a similar section were to be incorporated in the Public Inquiries Act it might read:

> No finding of misconduct on the part of any person shall be made against him until he has had reasonable notice of the substance of the misconduct alleged against him, and he has been allowed full opportunity to be heard in person or by counsel.

I would be remiss in my duty if I did not express my misgivings about this recommendation. The section in the federal statute has always seemed to me to be at variance with the constant reiteration of the principle that such an inquiry is not a trial, is in fact only a means of assembling information on which the commissioner or commissioners may base a report to the executive, and consequently cannot by its very nature include findings "against" any person, particularly in the sense contemplated by the Evidence Act. Such was the position taken by the Court of Appeal in the case stated by me at the request of counsel for Manfred Kapp and William L. Walton.[9] Certainly the distinction could still be drawn, but open recognition of the fact that one of the purposes of such an inquiry was the making of a finding of misconduct against any person must make it more difficult to do so. There is another distinction also to be made between comments on the conduct of any individual included in a commissioner's report and "findings" of misconduct against him. These refinements acquire substance when considered in the light of the prolonged inquiry with which this report deals. Nine individuals who

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[6] Ibid. p. 465.
[7] R.S.C. 1952 c. 154.
[8] Ibid. p. 464.
[9] Appendix C.

testified before this Commission have been charged with criminal offences, and four of them have already been convicted; the cases against others are still in progress and perhaps more are in contemplation. Then again, two of the witnesses have been disciplined by the Law Society of Upper Canada and four by the Institute of Chartered Accountants of Ontario. All of these proceedings, already concluded, began and ended before the completion of this report, and it may pertinently be asked at what point those against whom they were directed should have been given notice by me of the substance of the misconduct alleged against them. A commissioner's conclusions on such an important subject cannot fairly be drawn after hearing only part of the evidence to be presented before him, or, indeed, without considering all of the evidence which may be offered at public hearings, and all the evidence of a documentary nature produced before him, or made otherwise available before the affected party is invited to appear. I have made no actual count of the number of persons on whose conduct I have commented unfavourably in the course of writing this report, but it must be considerably in excess of the number of those against whom proceedings of some kind or another have been taken. Speaking only of the work of this Commission, I should have thought that the invitation, given to all persons affected by the evidence produced before it at the conclusion of that led by counsel for the Commission, to call such additional evidence as they might wish to present, announced at a public hearing and advertised in the press and the Ontario Gazette in April 1967, was all the notice that could reasonably be expected, having regard to the length of the hearings and the volume of the evidence. In any event it is with a sense of relief that I find myself not now bound to issue notices which are, in effect, summonses to show cause why I should not make findings of misconduct against men who have already been convicted and imprisoned as a result of my investigations, or who are now in jeopardy for the same reason. Although in principle Chief Justice McRuer's recommendation is admirable, it is to be hoped that its practical application will be carefully considered before legislation is introduced.

A word must also be said about section 2 of the Public Inquiries Act as it now stands. The recommendation of the McRuer Report embodied in section 7 of the Statutory Powers Procedure Bill, by which tribunals are relieved of considering the vexed question of their power to commit for contempt and allowed to certify such an offence to the High Court, is the right solution and should be incorporated in the Public Inquiries Act. It is proper for me to say that, throughout all the 126 days on which evidence was taken before this Commission, no act or expression of contempt for its proceedings occurred, or ever seemed likely to occur. The action taken by counsel for the Commission in acquainting witnesses beforehand with the general tenor of questions to be put to them must be judged chiefly responsible for this remarkable record.

Some difficulties, however, arose in connection with the production of documents, not in the sense that the documents required were ever withheld, but in connection with the orders to produce documents issued by me, the validity of which, although never challenged, was a source of some concern to myself and my advisers. The Rules of Practice of the Supreme Court of Ontario, designed to regulate proceedings of the parties to an action, lend themselves to the procedure of a commission of inquiry only by analogy, and the analogous situation is often difficult to define. This Commission also relied heavily on the resources of other agencies which enjoyed more effective powers; for instance, many witnesses were examined, as a preliminary to their appearance before the Commission, or in a purely exploratory way, individually and under oath, by virtue of powers conferred on the Commission's counsel and investigators under the Securities Act, and the Department of National Revenue (Taxation) of Canada made available documents seized in the course of investigations under the Income Tax Act. The invaluable assistance received from the Securities Commission and from the Department of National Revenue (Taxation) was wholly voluntary and might not always be available to a commissioner appointed under the Public Inquiries Act. For the future it would be advisable if the power to order production of documents, conferred by section 1 of the Public Inquiries Act, included that of issuing orders for this purpose in a prescribed form, not being a subpoena or summons to attend, without making it necessary to rely by reference on the powers "vested in any court in civil cases". A more delicate question is the power to enter and search premises and seize personal property. This is dealt with in chapter 31 of the McRuer Report which contains important and humane recommendations, carefully related to the liberty of the subject and the traditional sanctity of his home, but not, as I apprehend, dealing with any situation under the Public Inquiries Act which may, in the public interest, require the conferring of strictly limited powers in this respect on a commissioner operating under it. Here again the special character and needs of the investigation should be kept in mind.

My comments would be incomplete if I did not, in connection with the orders for production of documents issued by this Commission, refer to the high standard of co-operation observed by the chartered banks, and the dilemma which confronted the Royal Bank of Canada in making available details of C. P. Morgan's "Morgan Trust" account at its branch in Freeport, Grand Bahama. I have referred to the latter in Chapter VIII under the heading "Sir Stafford Sands' Position";[10] briefly the Royal Bank was quite prepared to supply details of depositors' accounts in Ontario and perhaps in any part of Canada, but felt that it was hampered in this respect by sections of the Banks and Trust Companies Regulation Act 1965 of the Bahama Islands, and their interpretation by the Minister

[10] pp. 472-3.

of Finance in that jurisdiction. A solution was at length provided by Morgan himself consenting to the disclosure of the Freeport ledger cards shortly before his death. The bank's situation was painful, and the problem which this situation presents to regulatory authorities is one for which no easy solution can be suggested. Much depends upon joint action by the government of Canada and those of its provinces, taken perhaps in conjunction with other governments, to minimize the advantages offered by the Bahama Islands, Switzerland, Lichtenstein, Luxembourg and the like, to those who seek to evade or set at nought the laws of the jurisdictions where they do their principal business. It is doubtful if any advantage can be gained by the unilateral action of one province of Canada, and it is even likely that its own business enterprises will suffer from a single-handed attempt to solve a problem of world-wide proportions. However the problem remains, and is of critical importance to the law-abiding business community in Canada which is prepared to conduct its affairs and pay its taxes according to the laws enacted by the Parliament of Canada and the legislatures of the ten provinces; this importance is enhanced by legislation now contemplated which would confer upon Canadian trust companies the power to invest in companies doing similar business and constituted abroad.

A problem which lends itself more readily to recommendation for legislative change is one, moreover, which is purely domestic. In this country we stand something like midway between the United Kingdom and the United States in the length of time required to despatch business in the courts. In recent years we have been moving closer to the situation of the latter where, to the astonishment of the outside world, many months, and sometimes years, are required to reach a decision in a civil or criminal case. This is chiefly due to the practice of allowing adjournments of proceedings for a variety of reasons, including not infrequently the fact that counsel for a party is required, or elects to proceed on some other matter in another court, a situation which, at a preliminary hearing of the case against one of the principal figures in the Atlantic Acceptance story, occasioned an adjournment for two months. This was not an isolated case, and other examples could be cited of delays at trial and on appeal for the same reason. Another pretext for delay, eagerly fastened upon by some experienced practitioners of commercial fraud, is the dismissal of their counsel at the threshold of, or in the course of a trial, and the employment of a substitute who may reasonably ask for an adjournment to prepare his case. In the United Kingdom and in other Commonwealth countries, where a case is prepared by solicitors, who then retain counsel from among the members of a relatively small bar specializing in advocacy, the problem rarely arises, perhaps because by tradition, if for no other reason, the time of the court is considered so valuable that a barrister's juniors, or another barrister retained on the spot, are, in the case of counsel's inability to carry on for any reason, expected to pro-

ceed forthwith. The problem also does not arise here in the case of trials by jury, where the continuous application of twelve or six laymen in a criminal or civil trial, as the case may be, is by custom considered of sufficient importance to preclude the breaking off and resumption of proceedings over an extended period of time. In criminal cases the County Court Judge's Criminal Court and those of provincial judges (formerly known as provincial magistrates), suffer excessively from delay through adjournment because of the absence of juries, and the tendency of judges presiding in them to grant adjournments when all parties consent. It has often been said that justice delayed is justice denied, usually in the case of an accused person, and it is true in cases where there are delays of many months created by the accused and his advisers, and the example of his conviction, long after the proceedings were begun, is lost to the public. There is often deep suspicion in the public mind when influential offenders, employing eminent and busy counsel whose services are apt to be required in many other causes, secure delays for this reason. It is hardly necessary to multiply reasons for concluding that the prompt and even-handed despatch of justice in the courts, particularly in criminal cases, is a prime requirement of any civilized society.

Delays arising from adjournments by judges do not, however, exhaust the list of those with which the administration of justice should be concerned. In former times in Ontario the Attorney General—now entitled by statute to the style of Minister of Justice and Attorney General of Ontario—was accustomed to retain counsel in private practice to act for the Crown as prosecutors, but since 1934 there has been a notable change of policy in this regard. The immediate reasons for it were not, perhaps, unrelated to problems of patronage, and the occasional incidence of large fees which provoked unfavourable comment; in any event the practice now is, subject to a few exceptions in cases of rare complexity, to have the Crown represented in prosecutions by its salaried employees, the County Crown Attorneys and their assistants, or by counsel in the criminal justice division of the department. I do not for a moment suggest that these professional public servants are lacking in energy or devotion to the task of law enforcement, but it would be idle to contend that they are all equally capable, or equally at leisure to conduct prosecutions in lengthy cases of complicated commercial fraud. The result is that the burden falls in unequal measure upon the shoulders of a handful of departmental officers who not only prepare but conduct the prosecution of the relatively few offenders whose cases it is within their human capacity to cope with. Commercial fraud has now reached such proportions in Ontario, not apparently unrelated to the operations of malefactors outside the jurisdiction, as to entitle the Minister to reconsider this policy, to make his staff primarily responsible for investigation and preparation and to retain the services of counsel outside the

department in practice at the criminal bar. I have had some experience, in another field of activity, of the departmental argument that staff should be multiplied and salaries raised to cope with the costs of increasing business, and to provide comparison with the large earnings of leaders in private practice; this is usually coupled with the argument that eminent counsel may be attracted to the public service by these means. The answer surely is to let the private practitioner do the laborious work and enjoy the emoluments of a successful professional career, but to establish the opportunity and, by custom, the requirement for his services from time to time to be placed at the disposal of the Crown.

There is another aspect of this important question which should not be overlooked. Over a period of thirty-five years the private sector of the criminal bar has, in general, been forced to practice as defence counsel, except in those cases where individual members have been retained by the Department of Justice at Ottawa to conduct prosecutions under the Income Tax Act, the Narcotics Act and other federal statutes. It is seriously open to doubt that the legal profession in Ontario benefits from a policy which ranges all the resources of its members in private practice on the side of the defence, and on the side of the Crown a professional bureaucracy which, however enlightened and closely associated with the profession as a whole, cannot be entirely free from the trammels of departmental policy, or act with complete independence as officers of the court. Such has not been the tradition of the English bar, from which we in Ontario, for over a century and a half, have derived many salutary principles and standards of conduct. For example, Sir Edward Marshall Hall and Lord Birkett acquired their fame as counsel for the defence, and are not generally associated in public or professional recollection with the prosecution of offenders; nevertheless, prosecute they did on retainer by the Treasury Solicitor or the Director of Public Prosecutions. Two principles are therefore at stake with the maintenance of which the Minister of Justice and Attorney General of Ontario, as head of the profession, can justifiably be concerned; the acceleration of law enforcement by making available to the Crown the resources of the criminal bar as occasion requires, and fostering the health and objectivity of the legal profession as a whole through closing the gulf in training and outlook now widening between practitioners in public employment and in private practice. If it is contended that this will impose additional burden upon the public treasury in the payment of fees, I beg leave to doubt that the expense will be greater, or even as great as may be entailed by any necessary reinforcement of the public service which the prosecution of commercial fraud might require to be undertaken as an alternative. In any event, expenditure on law enforcement is as essential to the welfare of a community as any made for education and public health, and the advantages of better business conduct, and effective deterrence of those who prey upon the unwary and the ill-informed, might be effectively

secured for comparatively little. Greater than any other need emerging from contemplation of the many transactions with which this report has been concerned is that of upholding, by resolute and determined measures, the standards of honesty and fair dealing under which business is customarily carried on in the Province of Ontario, and without which it cannot be safely transacted in any quarter of the globe.

RECOMMENDATION XVIII

*Consideration should be given, in consultation with the Government of Canada with respect to necessary amendments to the Criminal Code, with the Judges of the Supreme Court of Ontario with respect to necessary amendments to the Rules of Practice and with the Law Society of Upper Canada with respect to questions of professional conduct, to expediting proceedings in the Courts of the Province by limiting the number and length of adjournments obtainable on the application of any party, including the Crown, or upon consent.*

RECOMMENDATION XIX

*To secure prompt and comprehensive enforcement of the law against irregular or fraudulent practices involving companies carrying on business in Ontario, consideration by the Minister of Justice and Attorney General of Ontario should be given to retaining for the prosecution of offenders, as a matter of course, counsel not regularly employed by the Province.*

* * *

The protracted investigation of the affairs of Atlantic Acceptance Corporation, British Mortgage & Trust Company and of the many companies and individuals which were intertwined with them, must provoke general reflections at the conclusion of this report. It will be recalled that the Prime Minister of Ontario, at the conclusion of his statement announcing the constitution of this Commission, quoted in Chapter I,[1] said:

> "It will be our intent to ask the Royal Commission to also make recommendations as to what steps might be taken to ensure that the events which have been revealed in connection with Atlantic Acceptance Corporation Limited are not repeated in the future."

I have endeavoured, in the specific recommendations made in this concluding chapter, to suggest changes and safeguards in legislation, and by way of regulation, which will, if adopted, I hope make a repetition of the Atlantic disaster more difficult, coming as it did like a sudden and violent storm out of a cloudless sky in a season of sunny prosperity. After the

[1] p. 25.

storm many prospects were found to have darkened, and the wreckage left in its wake may still be discerned. There can be no guarantee that such a convulsion will not occur again, whatever legislation may be enacted or regulatory policy devised, because it had its origins in fraud and concealment, and it is yet to be demonstrated that laws of general application can be wholly successful in providing against the resolve of any human agency to twist and break them. In the case of fraud and theft, as in that of other forms of rapine, a great advantage lies with the aggressor whose determination to transgress, and to profit from his transgressions, may for long be successfully concealed. Thus, in a free society, the deterrent effects of vigilance by authority and condign punishment of offenders must inevitably be the main safeguards which law-abiding citizens can aspire to erect.

Many learned writers have demonstrated that in a simple homogeneous society the line between law and custom is difficult to draw, and that the earliest codes of law derived from even more ancient customary observances and moral principles of religious origin. In a complex and heterogeneous society enacted laws multiply in direct relationship to the elaboration of its material problems and social stresses, while a corresponding decline occurs in the force of custom and moral sanctions. Contempt for law is a sure symptom of a dissolving society, and nothing breeds contempt for law more surely than enforcing it unequally as between individuals and groups, or failing to enforce it at all. Practitioners of commercial fraud will always have victims who are susceptible to flattery and greed, but there will be fewer victims if the laws designed to protect them are more vigorously applied, and penalties exacted on a scale of frequency comparable to those achieved in other categories of crime, more easily detected and less harmful in their effect on public confidence. Prejudice is largely responsible for the belief that there is one law for the rich and another for the poor; nevertheless, there is some substance to this easy generalization in the field of commercial fraud, because of the difficulty of detection, the unwillingness of businessmen to prosecute their own associates and accept unfavourable publicity, and the sheer load of work which falls upon law enforcement agencies in keeping abreast of more blatant offences affecting public order and decency. The answer to the problem presented by adventurers like C. P. Morgan, W. L. Walton, Harry Wagman, Elias Rabbiah, Jack Tramiel, Eugene Last and others of that ilk, is to make transgression more costly by increasing the likelihood of detection, speedy trial and suitable punishment. As to what is suitable punishment it is not for me to say, but it is worthy of note that parole authorities have found swindlers and thieves more difficult to rehabilitate than offenders of a more violent and spectacular type.

It may be concluded therefore that an overwhelming majority of men and women in any civilized society are honest; some may be greedy

and others gullible, but their vulnerability arises from their observance of the golden rule; when the rule is broken and they suffer loss, there must always be somebody else to blame for consequences ruinous to themselves. A full measure of recrimination is bound to fall upon regulatory authorities established by government and paid for out of the common fund created by members of society for their own protection. It is one of the commonplaces of public service that the regular and efficient despatch of public business is taken for granted, whereas one failure of vigilance or foresight may ruin a career or disparage a whole administrative process. Therefore, I should take this final opportunity of saying that nowhere in the long and complicated history of Atlantic Acceptance Corporation and British Mortgage & Trust Company have I discovered any example of dereliction of duty by any public servant of Ontario. It may fairly be said, in the case of the trust company, that the management of Wilfrid P. Gregory was for some time treated with remarkable tolerance, but it must also be said that tolerance is based on trust, and regulation, like competitive business, would be impossible to undertake without it. Although I have suggested changes in the law and made observations based upon the evidence before me, I must acknowledge that the very large section of the public which engages in trade and commerce, and invests their proceeds in other commercial undertakings, can safely rely upon the goodwill and capacity for self-regulation of the professional and financial communities, always provided that they are assisted by active enforcement of the law, with ample protection assured to those who invoke it. This law should be framed in an atmosphere of careful deliberation, free from panic and discriminatory pressures, and, where its effect is salutary, enforced without regard to cost.

## CONSOLIDATED RECOMMENDATIONS

### Finance Companies

I. 1. All finance companies should achieve and maintain a state of total liquidity.

2. Total liquidity should be defined as maintenance of cash and unused bank credit equivalent to short-term debt maturing at any time.

3. The maintenance of total liquidity should be ensured by

(a) obtaining lines of credit from banks a substantial portion of which should remain unused, or

(b) obtaining stand-by lines of credit from banks, paid for at a rate which will ensure their availability although not used in the normal course, as now provided to finance companies by banks in the United States of America, or

(c) the maintenance of a portfolio of short-term investments readily convertible into cash, or

(d) any effective combination of (a)(b) and (c).

II. No trustee should act as such under the terms of any trust indenture securing the obligations of a finance company on behalf of holders of those obligations if he is already trustee under the provisions of a trust indenture on behalf of holders of obligations which rank higher or lower in priority of claim upon its assets.

III. 1. Where a finance company adds to the principal amount of a loan made by it as pre-computed interest charge for the purpose of securing repayment of principal and interest in equal payments over the life of the loan contract, the percentage of such pre-computed charge taken into income at the commencement of the life of the contract, and not deferred as unearned interest to be taken into account as earned, should be disclosed in any report made to the directors and shareholders of the company or holders of any type of security for loans made to it, together with an explanation of the method by which unearned interest thereon is subsequently taken into income.

2. Regular rebate tests of the accounts receivable of a finance company should be made and their results clearly and adequately disclosed in such reports.

IV. When the financial statements of a finance company and those of any subsidiary company are consolidated for the purpose of making a report on the financial situation of a finance company to its shareholders, and auditors other than those engaged to audit the accounts of the finance company are engaged to audit those of its subsidiary company, the auditors expressing an opinion upon the consolidated financial statements should rely on the work of other auditors only to the extent that they take responsibility for it, as if the relationship between them were that of principal and agent.

V. 1. Where the annual financial statements of a company or companies subsidiary to it are consolidated with those of a finance company, its annual report to the shareholders should contain the financial statements of both or all of them, separately reported upon by their auditors.

2. The fiscal years of a finance company and any company subsidiary to it should be coterminous in date, unless sufficient reason is shown for a different treatment and clearly explained in a note to the consolidated financial statements.

VI. 1. The directors of a finance company should be required to authorize all loans made, or which are at any time outstanding, to any borrower, or any borrowers associated one with the other to the knowledge of the directors, in any amount exceeding 5% of the excess of its tangible assets over its liabilities determined quarterly, on a consolidated basis where appropriate (excluding inter-company loans), to keep under review the conditions of any agreement to which the company or any subsidiary is a party under which money has been lent to them, and to furnish shareholders of such companies, and the holders of any obligations issued by them, with certificates from each director, annexed to the financial statements laid before any meeting of the shareholders, that, in the course of the period to which such financial statements relate, they have obtained no knowledge of the breach of any condition of any such agreement which has not been otherwise disclosed to the parties thereto.

2. The directors of a finance company should be entitled to rely, for the determining of the excess of tangible assets over liabilities, on the accuracy of unaudited statements prepared from the books of the company, certified by its chief financial officer and its president, unless they have reason to doubt their accuracy.

VII. In addition to the provisions of Section 122 of the proposed Business Corporations Act 1968, when a director of a finance company declares the nature and extent of his interest in any contract or transaction to which the company is or is to be a party, the minutes of any meeting at which such a declaration is made should record the nature and extent of the interest declared, and the correctness of the minute should be acknowledged by the signature of the director making the declaration.

VIII. 1. There should be an act to provide for the incorporation of finance companies in Ontario and the regulation of finance companies carrying on business, in Ontario within the limits of the jurisdiction of the Legislative Assembly of Ontario.

2. A finance company should be defined in terms similar to the definition of "public finance company" contained in section 1 of the Public Finance Companies' Investments Act 1966 S.O. 1966 c.124.

3. Notwithstanding the provisions of any other Act, a finance company should be incorporated by letters patent issued under the Great Seal.

4. The powers of a finance company should include those of making loans to the public and of borrowing from the public, on the security of its debentures, bonds and promissory notes subject to the provisions of the Securities Act.

5. There should be an Inspector-General of Finance Companies appointed by the Lieutenant Governor in Council on the recommendation of the appropriate minister of the Crown, under whom he should be responsible for the administration of the Act, inspection of the operation of finance companies from time to time and the obtaining and reporting upon such information as he deems necessary, or as may be required by the Act or any regulation made pursuant thereto.

6. No company should be permitted to carry on the business of a finance company in Ontario without a licence given by the Lieutenant Governor in Council upon the recommendation of the Inspector-General, terminable only after an inquiry by the Inspector-General and upon recommendation by him to the Lieutenant Governor in Council on such terms and conditions as the Lieutenant Governor in Council may see fit to impose.

IX. The Inspector-General should, in addition to such other information as he may request, be furnished with copies of all reports made by a finance company to lenders of money to it, and

should be empowered to require that such information be provided by the use of electronic data processing equipment at the company's expense, to an extent and in such a manner as he considers satisfactory.

X. 1. No action should be brought against any director or officer of a finance company to enforce any right, duty or obligation owed to his company only on the grounds that an action taken or decision made by him was not in the best interests of the company, unless it is alleged that such action was taken or decision made fraudulently, negligently or in bad faith.

2. In any such action, notice, security for costs and costs should be in the discretion of the Court.

3. Indemnification by a finance company of any director or officer against pecuniary loss, suffered as the result of an action brought by a shareholder of such a company in a representative capacity on behalf of the company against him, should be a question for its shareholders other than such director or officer.

XI. 1. No restriction by way of legislation or regulation should be placed on the freedom of a finance company to contract with lenders to it for the repayment of money lent.

2. Where application is made for the appointment of a receiver, receiver and manager or liquidator under the terms of any agreement entered into by a finance company as the borrower of money and the lenders to it, or their trustee, such appointment should be in the discretion of the Court.

3. The lawful requirements of the Inspector-General for the provision of information about the borrowing and lending of finance companies should not be regarded as a restriction contemplated in 1, and notice of any application made under 2 should be given to the Inspector-General, so that he may attend upon the return of the application before the Court and make such representations as he deems necessary.

## Trust Companies

XII. 1. Trust companies in Ontario should continue to be incorporated by letters patent issued under the Great Seal, upon petition to the Lieutenant Governor in Council and after consideration of a report by the Registrar on the sufficiency of the proposed by-laws of the company, its ability to provide service to the public, and the need therefor, and

compliance with the requirements of the Act as to subscription for stock having been received amounting in the aggregate to the minimum amount required by law.

2. The provisions of the Loan and Trust Corporations Act relating to registration and admission to registry of companies incorporated in Ontario, or under the laws of Canada or any of its provinces, or under the laws of any other country, should be retained, except that where the approval of the Minister is now required the approval of the Lieutenant Governor in Council should be substituted.

XIII. 1. Where the directors of a trust company are in doubt as to the legality of any claim to or upon any share or obligation of the company, or to or upon any payment to be made in connection therewith, they should apply for adjudication thereon to the Registrar who should hear the representations of any interested party before giving his decision, from which an appeal may be taken by any director or interested party to the Supreme Court of Ontario; upon compliance with the decision of the Registrar or, on appeal, the order of the Court by the company, its directors and officers, no action shall lie against them in respect of any claim arising from the matter determined.

2. No action should be brought against any director or officer of a trust company to enforce any right, duty or obligation owed to his company only on the ground that an action taken or decision made by him was not in the best interests of the company, unless it is alleged that such action was taken or decision made fraudulently, negligently or in bad faith.

3. In any such action, notice, security for costs and costs should be in the discretion of the Court.

4. Indemnification by a trust company of a director or officer against whom such an action has been brought by a shareholder of such a company in a representative capacity on behalf of the company should be a question for its shareholders other than such director or officer.

XIV. 1. The directors of a trust company should be required to lay before the annual meeting of its shareholders financial statements for the financial year immediately preceding it, consisting of a balance sheet, a statement of income and expenditures and undivided profits and a statement of accumulated appropriations for losses or general reserve in a form prescribed either by regulations made as authorized by the Act or in any schedule thereto.

2. These statements should exhibit such figures relating to the financial position and operations of the company in, at least, the fiscal period immediately preceding the one under review by the annual general meeting as will provide the shareholders with a full comparison of them for both periods.
3. In their report the auditors of the company should state, with respect to each of the statements enumerated in 1., whether it presents fairly the financial position of the company, the results of its operations and the transactions in the reserve account, in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.
4. Where an auditor is unable or declines to express an opinion on any such statement in the terms set out in 2 above, he should state his reasons fully in his report.
5. An audit committee consisting of not less than three directors of a company, the majority of whom should not be officers of or otherwise employed by the company, should review the company's financial statements before approval by the board of directors and should confer with the auditors at any time at their own request, or at the request of any auditor.

XV. 1. A trust company having paid-in unimpaired capital of at least $1,000,000 should have power to borrow money by issuing terminable debentures, provided that the provisions of subsection 2 of section 80 and subsection 3 of section 82 of the Loan and Trust Corporations Act, or others to the same effect, segregating and setting aside cash and securities to ensure repayment of deposits and money received for guaranteed investment respectively, continue in force, and that depositors and guaranteed investors rank ahead of holders of such debentures as creditors of the company in any claim upon its assets.

2. No such debentures should be issued unless approved beforehand at a general meeting of the company's shareholders to whom due notice of the question to be decided shall have been given, as well as to the Registrar who should be entitled to attend and be heard in person, or through a representative appointed by him.

XVI. 1. A trust company should confine its investments in real estate to such as are required for its own purposes in the opinion of the Registrar, or as authorized by the Lieutenant Governor in Council, and, for the purpose of producing income only, to "improved real estate" as defined by statute.

2. The amount of money invested by a trust company in any mortgage of improved real estate of leaseholds, together with the amount of indebtedness secured by any other mortgage of the same property not subordinate to it, should not exceed 75% of the value of the real estate or leasehold, unless repayment of the excess of the investment over that amount is insured with a registered insurance company.

3. A trust company should only lend money on the security of bonds, debentures, notes, stocks or other securities of any company or bank having an established market value approved by the Registrar, and only when that market value exceeds the amount of the loan for which such securities are pledged by at least 20% of their market value at all times, provided that the amount lent on the security of the stocks of any such company or bank does not at any time exceed 10% of the established market value of the total outstanding stocks of such company or bank.

4. A trust company should at all times keep invested at least 50% of money received as deposits, or for guaranteed investment, in such securities as are authorized by the Trustee Act.

5. To facilitate the payment of claims by depositors and the holders of guaranteed investment certificates, a trust company should maintain, to the value of not less than 20% of the amount of deposits, and of funds received for guaranteed investment coming due in less than 100 days, cash and lines of credit from chartered banks in Canada, and such investments in securities maturing in 10 years or less, as may be approved by the Registrar.

6. Except as to securities issued or guaranteed by the Government of Canada, or of any province of Canada, or by any municipal corporation in Ontario or city in Canada, and in the paid-up capital stock of any company control of which is permitted to it either by statute or by leave of the Lieutenant Governor in Council, a trust company should not invest any of its own funds or money received as deposits or for guaranteed investment in any one company or bank, by way of purchasing stock or other securities or lending on the security of debentures, mortgages or other assets or any part of them, an amount exceeding 15% of its own paid-in capital stock, plus its unallocated reserve funds as determined annually by the Registrar.

XVII. 1. In addition to the powers conferred upon the Registrar as to a special audit by section 114 of the Loan and Trust Corporations Act, he should be authorized to consult and employ such accountants, lawyers, and other professional advisers as the urgency of any particular case requires.

2. Suspension or cancellation of the right of a trust company to do business in Ontario, by removal of its name from registration under the Act or any other means, should be effected by Order-in-Council after consideration by the Minister of a report made by the Registrar.

3. Forthwith after the signature of the minutes of any meeting of the board of directors of a trust company, or of the minutes of any committee thereof, by the officers authorized to do so, certified copies should be furnished to the Registrar.

4. The annual statement of the affairs of a trust company supplied to the Registrar should be accompanied by certificates from each of the directors of the company and each of its auditors, certifying that no breach of any of the provisions of the Act, or of the rulings made thereupon from time to time by the Registrar, has come to their attention during the period to which such annual statement applies if such be the case, or setting out the nature and extent of such breaches as may have come to their attention during such period.

5. The Registrar may require that copies of correspondence between himself and officers of a trust company should be furnished to each member of the company's board of directors, and should take such steps as he considers necessary to see that this is done.

6. As a supplement to the provisions of section 118 of the Loan and Trust Corporations Act, the Minister should be empowered, upon the report of the Registrar that a trust company's assets are not satisfactorily accounted for, or not sufficient to give adequate protection to persons who have advanced money to it by way of deposit or loan, or the operations of which have been in substantial and deliberate breach of prohibitions or limitations imposed by the Act, to direct the Registrar to take control of any or all of the company's assets for such period as he considers necessary to accomplish

(a) The reorganization of the company upon a basis consistent with the provisions of the Act, and the security of its depositors and holders of its guaranteed investment certificates, or

(b) the securing of an order by the Supreme Court of Ontario for the appointment of a receiver and manager of the company, or

(c) the cancellation of its registration after securing to the best of his ability the interests of its depositors, guaranteed investments, owners and beneficial owners of assets under its administration.

7. The Minister, the Registrar and such officers and agents as they may appoint for the purposes set out in 6, should not be liable, or, if liable, should be indemnified for any damages or costs incurred as a result of any claim made against them for any action taken by them in good faith while a company's assets are under the control of the Registrar.

## GENERAL

XVIII. Consideration should be given, in consultation with the Government of Canada with respect to necessary amendments to the Criminal Code, with the Judges of the Supreme Court of Ontario with respect to necessary amendments to the Rules of Practice and with the Law Society of Upper Canada with respect to questions of professional conduct, to expediting proceedings in the Courts of the Province by limiting the number and length of adjournments obtainable on the application of any party, including the Crown, or upon consent.

XIX. To secure prompt and comprehensive enforcement of the law against irregular or fraudulent practices involving companies carrying on business in Ontario, consideration by the Minister of Justice and Attorney General of Ontario should be given to retaining for the prosecution of offenders, as a matter of course, counsel not regularly employed by the Province.

ALL OF WHICH I RESPECTFULLY SUBMIT FOR YOUR HONOUR'S CONSIDERATION.

*Commissioner*

Osgoode Hall,
Toronto,
September 12, 1969.

# *Acknowledgments*

As soon as the failure of Atlantic Acceptance Corporation Limited became known, the Attorney General of Ontario, the Honourable Arthur A. Wishart, Q.C., instructed the Ontario Securities Commission to examine its affairs. Its chairman, Mr. J. R. Kimber, Q.C. (now president of the Toronto Stock Exchange) took the lead in urging the appointment of a commission of inquiry upon the government because he had early experience of the size and complexity of the task and thereafter put the services of the Securities Commission and its staff at my disposal to assist the Royal Commission in the commencement of its investigations. The help and co-operation then extended continued throughout the period of his chairmanship and that of his successor, Mr. Henry F. Langford, Q.C., and I am much indebted to them and their colleagues and staff, and in particular to Commissioner D. S. Beatty, formerly a governor of the Toronto Stock Exchange, upon whose experience and knowledge I have frequently drawn. I have earlier acknowledged, and am glad to record again my debt to the Honourable Mr. Justice Arthur Kelly, who was completing his report of the Royal Commission on Windfall Oils & Mines Limited when I was embarking on the Atlantic inquiry, and who gave me not only much valuable advice but greatly facilitated the transfer of his Commission's office accommodation to me and my staff at considerable inconvenience to himself and his own. The unfailing assistance of the Deputy Minister of Justice and Deputy Attorney General, Mr. A. Rendall Dick Q.C., and his officers in all administrative matters was a source of comfort from first to last.

The failure of Atlantic Acceptance had important international implications, and the Commission is indebted especially to the United States Securities and Exchange Commission for unstinted co-operation in the course of its investigation. The attempt to affect the market for shares of Racan Photo-Copy Corporation Limited, by placing orders for the purchase of a number of stocks accompanied by forged cheques in the name of a fictitious company, Sassoon's Far Eastern Trust Limited, gave the Securities and Exchange Commission jurisdiction to conduct an investigation in the United States, and valuable exchanges of information in consequence took place. Through the good offices of Mr. Manuel F. Cohen, until recently Chairman of that Commission, I was able to discuss common problems with many of its senior officers,

and counsel and myself at all times worked closely with Mr. Peter J. Adolph, at the time Attorney in its Division of Trading and Markets and now Assistant Chief Counsel in the Office of Direct Foreign Investments of the Department of Commerce, who was particularly charged with responsibility for the Sassoon's Far Eastern Trust investigation, and whose enthusiasm and energy in facilitating the work of this Commission were beyond praise. Brief but useful discussions occurred in August 1966 in the United Kingdom with Mr. C. W. Jardine, Under Secretary in charge of the Insurance and Companies and Bankruptcy Departments of the Board of Trade, and with Mr. S. D. Musson, C.B., M.B.E., the Chief Registrar of Friendly Societies. In acknowledging their assistance in answering numerous questions and furnishing me with a number of documents, I must also express my thanks to Major J. E. P. Armstrong then Agent General for Ontario and his executive officer Mr. A. Emslie who arranged these interviews and made numerous enquires for the Commission at short notice.

My visit with counsel to Germany, in the same month, to obtain information about the affairs of the Hugo Oppenheim Bank would not have been possible without the advice and help of the Department of External Affairs, and I express my thanks in particular to Mr. M. H. Wershof, Q.C., then in Ottawa as Legal Adviser to the Department, now in Copenhagen as Ambassador of Canada, to Mr. R. P. Bower our Ambassador to the Federal Republic of Germany, and to Mr. Derek Fraser of the staff of the Embassy at Bonn and Mr. Dennis Butler of that of the Consulate-General at Hamburg who accompanied us on different occasions as Canadian Vice-Consuls. The arrangements to permit a foreign investigating body to take evidence in West Germany, even on an informal and voluntary basis, involved questions of some delicacy, and their success was complete. Mr. Wershof was also instrumental in enabling me to have a conversation with Mr. W. H. Sweeting, C.B.E., Chief Secretary to the Governor of the Bahama Islands, in April 1966, through whose good offices the Registrar-General of the Colony supplied the Commission with a number of copies of company incorporation records free of charge.

The Commission's adviser on all matters involving liaison in West Germany and its financial institutions was Mr. Silvester von Herrmann, of Burns Brothers & Denton Limited of Toronto, who accompanied us and, in addition to making all administrative arrangements, acted as interpreter. To him and to his firm for making his services available the Commission is greatly indebted, as it is to Wood, Gundy Securities Limited of Toronto for making available the services of Mr. J. N. Abell, whose invaluable report on the Effect of the Failure of Atlantic Acceptance on the Money Market constitutes the substance of Chapter XIX; he interviewed numerous company and institutional officers, both here and in the United States, whose assistance was essential to his work. It

is proper to state that these two companies were compensated for the services of both Mr. von Herrmann and Mr. Abell, but at rates and over periods of time which involved genuine sacrifices in the public interest. The Commission is also beholden to Mr. Louis Rasminsky, C.B.E., Governor of the Bank of Canada, and to members of his staff for much valuable advice and information given to Mr. Abell in the course of preparing his report, and for this, and discussions helpful to myself, I am most grateful.

From the beginning of the investigation and throughout its course Chief Constable J. A. Mackey, Chief of Police of Metropolitan Toronto, authorized the attachment of members of the Fraud Squad of the Metropolitan Toronto Police. These were at different times Detective-Sergeant R. C. McMaster, Detective-Sergeant C. Angus, Detective W. A. Smythe and Detective M. H. Wilson. At the same time, but for a shorter period, Detective-Sergeant (now Inspector) R. C. Barron of the Ontario Provincial Police was attached to the Commission; the knowledge and experience of these officers conferred very great advantages upon it which cannot be sufficiently measured by a bare acknowledgment here of my debt to Chief Constable Mackey and Commissioner E. H. Silk, Q.C.

My debt to counsel is difficult to express in becomingly moderate terms. The task of presenting the massive and complicated evidence of the transactions of Atlantic Acceptance Corporation and British Mortgage & Trust Company, and of the affairs of a multitude of other companies and individuals, was perhaps the most formidable ever undertaken in any inquiry of this type in Canada, not only because of the volume of documents to be considered but because so much had been concealed, or deliberately complicated to make the available evidence unintelligible. The first five months of the Commission's existence had consequently to be spent not only in ascertaining the course of events over a period of twelve years, but in detecting the motives behind a multitude of transactions for which there was little rational explanation on the surface; at the same time the work of many chartered accountants, retained by the Commission to examine and analyse corporate and accounting records on a very large scale, had to be directed and co-ordinated in the shortest possible time, accompanied by numerous preliminary examinations of witnesses and constant liaison with the Montreal Trust Company, receiver and manager of Atlantic Acceptance Corporation, and its liquidator, The Clarkson Company Limited. The burden of all this fell primarily and in the first instance upon the shoulders of Mr. A. E. Shepherd, Q.C., whose work at this stage and in the course of fifteen months of public hearings, during which he examined most of the witnesses, required all his time and energy expended literally night and day, and the loss of the services of their senior partner to Messrs. Shepherd, McKenzie, Plaxton, Little & Jenkins at London, Ontario. This work was ably seconded by the Commission's

Assistant Counsel, Mr. R. I. Cartwright, who conducted a very large number of examinations under the Securities Act and the examination of many of the witnesses at the public hearings of the Commission, with which he remained to do additional work after the bulk of the evidence had been presented. It is hardly necessary to say that I have relied upon the assistance and advice of Mr. Shepherd at all stages of my work as Commissioner, both in the conduct of the Commission's public hearings and in the preparation of my report, and upon that of Mr. Cartwright until October 1968, when he left the firm of Thomson, Rogers of Toronto to assume a position as counsel in the Ontario Department of Justice.

As my report makes plain, almost all the technical evidence given at the public hearings of the Commission was produced by chartered accountants. Its preparation, under the general direction of counsel, was the responsibility of Mr. John A. Orr, F.C.A., a partner in the firm of Touche, Ross, Bailey & Smart (now Touche, Ross & Co.), and evidence was given in the greatest detail by himself and members of his own firm and of Clarkson, Gordon & Co., who were actively engaged in the affairs of Atlantic Acceptance Corporation on behalf of the Montreal Trust Company. The only exception to the employment by the Commission of these two firms was that of Harbinson, Glover & Co., also of Toronto, in connection with the affairs of Arcan Corporation, and of Mr. F. E. A. Jackson, C.A., formerly an examiner on the staff of the Registrar of Loan and Trust Corporations. The accounting work was necessarily prepared under pressure of the need to begin public hearings as soon as possible after the constitution of the Commission, and to keep these in almost continuous progress from January 1966 to May 1967. Additional work was also necessary, often commissioned at short notice, as the writing of the report proceeded. Its importance, and the extent to which I have relied on it, cannot be over-emphasized. Although the Commission is heavily indebted to all the able practitioners who worked for it and gave evidence before it, I must be allowed to mention in particular among them Mr. Orr himself, Mr. A. W. Moreton, C.A. and Mr. B. Wolfman, C.A., upon whose time and patience I have imposed exceptional trials, borne in a manner which has especially deserved my thanks. Here I should also acknowledge the ready assistance at all times of Mr. Cecil Richards F.C.A., formerly Superintendent of Insurance and Registrar of Loan and Trust Corporations for Ontario, and of Mr. R. hrys ~~Humphreys~~ F.S.A., Superintendent of Insurance for Canada who kindly provided me with material and information in Ottawa. I am grateful, as well, to Mr. Laurence C. Crawford, F.C.A., of Crawford, Smith & Swallow, chartered accountants in Niagara Falls, Ontario, for his advice and help.

I have left to the end, not to diminish but rather to emphasize its importance, my acknowledgment of the unwavering assistance and support given to me by the staff of the Commission under the direction

of the Secretary, Lieutenant-Colonel J. B. Lind, C.D., whose admirable conduct of the many-sided administrative work of the Commission has relieved me, if not of responsibility, of all anxiety from the beginning to the end of my laborious task. In this he was ably assisted by the Registrar, Mr. V. F. Cunnington, who attended all the hearings and was responsible for over 5,000 exhibits entered in evidence, as well as the Commission's library which housed them and much more material besides, and by Mrs. Helen McPhee, the Chief Clerk, whose organizing ability and comprehensive knowledge of all the Commission's transactions were invaluable throughout its work. The burden of typing and re-typing the text of this report, and the numerous drafts and notes which were prepared in the course of its composition, fell principally on Miss E. Morgan, Mrs. L. Constand and Mrs. E. Binnerts, and this was undertaken and discharged in accordance with the highest standards of the stenographic art. The Commission was fortunate in having, in the years 1967, 1968 and 1969 respectively the services in the long vacations of Mr. Gordon M. Edwards, an undergraduate of the University of Toronto Law School, Miss Vida Wilson, an undergraduate of the Queen's University, Belfast, and Miss Louise Ribbans, an undergraduate of St. Michael's College in the University of Toronto, who made distinct and valuable contributions at different stages of the work. The task of seeing the report through the press was undertaken by the Secretary and Major Peter Moore, C.D. It was by no means light and consumed the summer months of 1969.

In conclusion I wish to express my admiration for the way in which the public was kept informed of the progress of the investigation, and the many questions raised at public hearings, by the representatives of the press who attended the latter with great regularity. The task of conveying the sense and atmosphere of evidence which at times was of the most complex character was a formidable one, particularly when the opportunity of scrutinizing and analysing documentary evidence was not vouchsafed. To the diligent and informed reporting of this evidence must be attributed, in substantial measure, its contemporaneous effect on public opinion in the political and business communities. The verbal evidence itself, in all its complexity, was taken in shorthand and transcribed by the Supreme Court Reporters of the Ontario Department of Justice who supplied "daily copy"—a transcript of the proceedings of the immediately preceding day—throughout the Commission's hearings, a taxing task requiring relays of reporters and not normally required in the courts. The high standard of accuracy maintained under these conditions is the more remarkable and the indebtedness of the Commission the more pronounced.

Finally to my brethren of the High Court of Justice, who have shared the additional work of an absent colleague, apologies and thanks are due.

# Index



Vol. 1, pp. 1-678: Vol. 2, 679-1265: Vol. 3, 1266-1695.